

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
D. WEINSTEIN and C. WEINSTEIN,) OTA NO. 21037384
)
) APPELLANTS.)
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TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Thursday, March 14, 2024

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Proceedings,
taken at 12900 Park Plaza Drive, Suite 300,
Cerritos, California, 90703, commencing at
9:40 a.m. and concluding at 10:40 a.m. on
Thursday, March 14, 2024, reported by
Ernalyn M. Alonzo, Hearing Reporter, in and
for the State of California.

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APPEARANCES:

Panel Lead: ALJ KENNY GAST

Panel Members: ALJ HUY "MIKE" LE
ALJ EDDY Y. H. LAM

For the Appellant: D. WEINSTEIN
MICHAEL BERNSTEIN

For the Respondent: STATE OF CALIFORNIA
FRANCHISE TAX BOARD

SONIA WOODRUFF
BRIAN MILLER

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1A-19 were received into evidence at page 6.)

(Department's Exhibits A-F were received into evidence at page 7.)

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Cerritos, California; Thursday, March 14, 2024

9:40 a.m.

JUDGE GAST: We are on the record.

This is Appeal of Weinstein, OTA Case Number 21037384. Today is Thursday, March 14th, 2024, and the time is approximately 9:39 or 9:40 a.m. This hearing is being held in Cerritos, California with the agreement of all the parties.

My name is Kenny Gast, and I am the lead Administrative Law Judge for this appeal. With me today are Administrative Law Judges Mike Le and Eddy Lam.

At this point, I'd like to ask the parties to please identify yourself by stating your full name, first and last, for the record, beginning with Appellants.

MR. WEINSTEIN: Donald Weinstein.

MR. BERNSTEIN: Michael Bernstein.

MS. WOODRUFF: Sonia Woodruff.

MR. HALL: Nathan Hall.

JUDGE GAST: Thank you.

And there is one little housekeeping item that I wanted to cover on the record. We originally had Judge Sheriene Ridenour for this appeal. She's unable to make the hearing, so we had Eddy Lam as her replacement. So I wanted to ask the parties if they have any objections

1 for Eddy Lam replacing her.

2 I'll start with the taxpayers.

3 MR. WEINSTEIN: No objection.

4 MR. BERNSTEIN: No objection.

5 JUDGE GAST: Thank you.

6 MS. WOODRUFF: And no objection from the FTB.

7 JUDGE GAST: Thank you.

8 Okay. We have one issue for this appeal. It's
9 whether Appellants have substantiated their cost basis in
10 the disposition of their stock in Photo Impact, Inc., for
11 the 2015 tax year. And I will note that -- I know the
12 parties agreed to the word cost, but I also think adjusted
13 basis is maybe more appropriate since there were
14 subsequent things happening that may have increased or
15 decreased the basis. I just want to note that.

16 Okay. With respect to exhibits, Appellants have
17 provided Exhibits 1-A through 19, and FTB did not object
18 to the admissibility of these exhibits. So these exhibits
19 will be admitted into the record.

20 (Appellant's Exhibits 1A-19 were received
21 in evidence by the Administrative Law Judge.)

22 JUDGE GAST: FTB has provided exhibits A through
23 F. Appellants have not objected to the admissibility of
24 these exhibits and, therefore, these exhibits are entered
25 into the record.

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

JUDGE GAST: Okay. With that said, I would like to turn it over to the taxpayers for 25 minutes or a little bit more. Before I do that, I'd like to swear in Mr. Bernstein just in case you say things that you intend to be factual and admitted into the factual record.

So if you would raise your right hand.

M. BERNSTEIN,

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

JUDGE GAST: Great. All right. Please begin whenever you're ready.

PRESENTATION

MR. BERNSTEIN: Okay. The way we'd like to present this -- first of all, thank you for allowing us to present our support -- is I'm going to have Don give you a little background on himself for a couple of minutes. And then I'm going to present more factual information, support. And then he may make some comments at end after me. That's how I'm going to --

1 Anyways, so Don go ahead.

2 MR. WEINSTEIN: Well, thank you for letting us
3 have the opportunity to present our side of it. And I
4 just wanted to let you know a little bit about, you know,
5 me and my business.

6 This last March 1st, a couple weeks ago, was the
7 anniversary of my 44th year in business. I opened
8 March 1st, 1980. And for a good almost 30 --

9 JUDGE GAST: I'm sorry, Mr. Weinstein.

10 MR. WEINSTEIN: Yes.

11 JUDGE GAST: Can I stop you real quickly. It
12 seems to be you're discussing facts. Do you want to be
13 sworn in as well?

14 MR. WEINSTEIN: Sure.

15 JUDGE GAST: Okay.

16

17 D. WEINSTEIN,

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

21

22 JUDGE GAST: Thank you. I'm sorry. Please
23 proceed.

24 MR. WEINSTEIN: Okay. I just wanted to give you
25 background of what business and how my business has

1 changed what's happened that kind of goes with everything
2 that's happening. You know, for almost 35 years I was a
3 commercial, sort of, very exclusive black and white photo
4 lab. And then as digital imaging came in, and it started
5 changing my industry. It's -- what happened is, as that
6 started happening and my business in film and printing
7 started going down because of digital imagining.

8 Like any business owner, I put money into it to
9 keep it going. At the height of my business, I had 35
10 employees. And when I changed over from an ink and closed
11 that, I had about 4. So I tried to keep it going. That
12 changed in about 2015, 9 years ago. And since then I've
13 been able to maintain my business in an industry in
14 Hollywood where at the height of that 35 employees, there
15 were 50 photo labs within a 5-mile radius and now there's
16 3. So I did everything I could to maintain and keep my
17 business going as long as I could.

18 And I just want to say, being sworn in that I
19 attest in front of all of you that all the funds that I
20 have put in over the years, I have put them in. And
21 Michael will go over that and show you what -- what I've
22 done and what I've put in to keep my business rolling. So
23 in the last nine years, thank God, I changed the business.
24 I went into more digital imaging instead of what I was
25 doing, more analog before. And I changed with the times,

1 and that's what helped me maintain what I've done.

2 I think in ending, you got to realize what
3 digital imaging did to the photo lab business was -- look
4 at Kodak. Kodak was one of the biggest companies in the
5 world, and they went through a billion-dollar war chest
6 trying to keep their business going, trying to maintain
7 through all the years, and they end up going bankrupt.
8 Polaroid went out of business. These are major companies,
9 you know, that tried to sustain what was happening.

10 So that gives you a little bit of background of
11 what my industry has gone through and what I try to do,
12 and thank God, was able to sustain it.

13 Thank you.

14 MR. BERNSTEIN: Forgive me if I read a little bit
15 because I prepared items. Please interrupt if you have
16 any questions.

17 So first let me tell you that I've been assisting
18 Don with his tax preparations since 1987 when I became an
19 EA, enrolled agent. My father before me, who had bought
20 the business from, did the years for Don before that. So
21 he's been with our family the entire time. I attest right
22 here and now that I have personal knowledge from
23 conversations with Don; review of bank statements,
24 ledgers, and other financial statements that were given to
25 me to the do the tax returns -- corporate tax returns that

1 he's made -- I believe he made those contributions that
2 shows the adjusted basis. I did not participate in his
3 internal bookkeeping, but I was observing Photo Impact's
4 evolution in realtime, that he described just now, during
5 the years from 1987 to 2015 when he dissolved the
6 corporation.

7 Next, please know that when I discuss debits,
8 credits, NOLs, capital contributions, my goal here is not
9 to educate you. You all have a lot of knowledge. I've
10 read the resumes. But I'm going to be using those terms
11 in a way that helps me to make the case for -- for Don.
12 Okay. I believe the tax records, bank and other records,
13 and the verbal testimony combined, provide reasonable
14 evidence to allow the cost basis or the adjusted basis for
15 Photo Impact stock. So I'm going to give you a timeline,
16 and then I'm going to go over some of the submissions that
17 we provided.

18 Pre-1985 Don was a sole proprietor from 1980,
19 when he mentioned, until 1985, and then decided to
20 incorporate to a C corporation. I believe when I sold to
21 my father when he was alive, it was a C corp rather than
22 an S corp because money was going to be put back into the
23 company to grow it. And as oftentimes why small operators
24 will be C corporations. In 1985 he incorporated. Assets
25 from the sole proprietor were contributed to the Photo

1 Impact, Inc., in exchange for the stock, I believe in a
2 351 recognition -- nontax recognition and corporation.

3 Charles Bernstein, my father, did the tax work
4 for Don prior to me.

5 THE STENOGRAPHER: Mr. Bernstein?

6 MR. BERNSTEIN: Too fast?

7 THE STENOGRAPHER: Please slow down a little.

8 MR. BERNSTEIN: Sure. Do you want me to re-read
9 anything.

10 THE STENOGRAPHER: No.

11 MR. BERNSTEIN: Okay. Thank you.

12 I believe the S corp was utilized for the profits
13 in the early years back in the company, and Don's wages is
14 how he received compensation. And he received
15 compensation in, I think, virtually ever year. Even loss
16 years, Don took wages because he treated it like this
17 other company that was paying him to do work, even if he
18 had to put money into the company. Approximately 1985 to
19 1995, the corporation made good profits. The industry was
20 doing well. He was making plenty of money. He employed
21 lots of people in California. Mid- 1990s though 2000
22 heavy losses due to industry changes resulted. Don
23 contributed money he had, borrowed money against his
24 house, and put money in -- put money into the corporation.

25 Don and I had many consulting meetings over the

1 years deciding how to change his operations to make it
2 profitable. You might be wondering why he isn't an S corp
3 at that time since there were losses. They could pass
4 through. Well, Don is the ultimate optimist. And he
5 said, okay, we have a year of losses. You've explained to
6 me they'll get stuck in the C corporation if I change into
7 an S. Corporation, but I'm going to make a profit next
8 year. So we can use that NOL against the profit. Well,
9 fast forward many years of losses, and he was still the
10 optimist. And that's sort of why we didn't change because
11 it would always get stuck in a C corporation.

12 Many black and white photo labs were now losing
13 money and shutting down. 2000 to 2015 losses were less
14 but still were happening. Don was taking a wage during
15 many of these years and was still employing several
16 people. Don then dissolved the organization as of
17 6/30/2015, which I believe would be the 14 corporate
18 return because it's a fiscal year. In large part to
19 change the direction of the company and handle more
20 digital imagery, he had to remake himself. The company he
21 now operates is Photo Impact Imaging LLC and is
22 profitable.

23 So the next area I would like to go into is sort
24 of how we came about our position that the documents we
25 provided will support adjusted basis. I'd like to go

1 through the corporate returns, not through the physical
2 corporate returns, but over what we did with the corporate
3 returns. NOLs have been shown on many of the tax returns.
4 And net operating loss is an NOL, just in case. Okay.
5 NOLs are produced from operating losses. Operating losses
6 are produced by expenses exceeding income in a particular
7 year. Money must be used to produce these losses, either
8 through buying assets that are being depreciated or paying
9 for expenses. Money must be available to make these
10 expenditures through corporate borrowing from a third
11 party or contribution of capital or loans by the owner.

12 When the corporation receives loans or
13 contributions from an owner, the entry will be a debit to
14 corporate cash loans and a credit to either loans payable,
15 shareholder, or shareholder capital contributions. The
16 funding actually came from corporate credit cards,
17 corporate loans, but mostly from money put in by Don from
18 his own reserves and his own borrowing. These are
19 reflected in the corporate returns. The Franchise Tax
20 Board indicates that Don cannot prove he put in all the
21 funds. I believe that's the issue. I can't prove that.

22 Well, I don't know what others think in this room
23 or have experienced, but in my 35 years of operating, I
24 have yet to see a stranger volunteer their money and put
25 that money into the corporation to help that corporation

1 audit, while not getting something from it. Either they
2 would get stock for their contribution, or they would get
3 a loan note from Don or from the corporation. There's
4 none of that happening. I believe it's very reasonable to
5 believe that no one else has put money into this
6 corporation to fund these losses but Don. Even if a
7 friend gave Don money to put it in, it would still have
8 gift basis for Don to put in and -- and allow for adjusted
9 basis.

10 As far as record keeping, which Don will talk
11 about when I'm done, Don had record -- many -- had records
12 for many years at the building that he sold, where this
13 business operated. Some were damaged or soiled over the
14 years due to small floods and things, and other times he
15 moved them around a little bit. But mostly I believe Don
16 felt that most of the records were on digital format in
17 terms of the accounting program or scanning documents or
18 saving documents. But as we well know, some of the old
19 programs used DOS or those programs the companies went out
20 of business and no longer could access. Some of the areas
21 we're having problems with, getting old documents.

22 Contemporaneous entries of debits and credits in
23 the corporation returns are important support items for
24 his claim of contributing money. Most of these comments
25 I'm making right now talks about the fact that corporate

1 returns were filed every year, accepted by the IRS as
2 filed, not questioned, no changes up through the date of
3 dissolution. Even now the Franchise Tax Board did not ask
4 during the audit to get any of the records from the
5 corporation itself. Didn't want to audit the net
6 operating losses. Would not question the expenses in the
7 corporation, even though I brought that up in audit.

8 The Franchise Tax Board would have you believe
9 that although they accepted these state corporate filings
10 with NOLs over 25 years, they somehow believe there were
11 25 years of falsely filed returns that we are anticipating
12 in 30 years from now there might be a capital gain that we
13 could utilize to offset this capital loss. I feel like
14 that's a bridge too far, and I believe the information the
15 corporation does provide some support for the adjusted
16 basis at the personal level.

17 With that said, I'd like to offer some direct
18 support as opposed to the ancillary support of the
19 corporate returns. I'm going to refer to a couple of
20 exhibits. Exhibit 1 is -- I'm not going to go through
21 many of these returns, just one and some other items. The
22 first exhibit is the 2000 tax return, which is the
23 earliest tax return I could have my IT people resurrect.
24 And on it, on the balance sheet, there is the original
25 stock contribution. I believe the number is \$43,522.

1 Now, I'm trying to understand why the Franchise
2 Tax Board would not allow that. Are they asking for us to
3 get the purchase items for the sole proprietor that
4 produced the net adjusted assets that were transferred
5 into the corporation, along with the cash to create the
6 initial stock, which was on the returns from 1985 until it
7 dissolved in 2015, although that wasn't discussed by them.
8 Seems to me that they're not even asking anything about
9 the incorporation. Yet, on the depreciation schedule --
10 if you would look into the return a couple of pages
11 back -- the first entry is an entry that says \$34,822 of
12 equipment less \$2,706 prior depreciation taken, gives an
13 adjusted basis \$32,116. All this does not match the
14 \$43,522. The only assumption I can make was the rest was
15 cash contribution. I don't have the that record, but
16 that's how I believe it came about to begin with. So
17 that's the first bit of basis that started.

18 Then if we go to 2020, that's the -- I'm sorry --
19 not 2020. It's too late. The 2014 return, which is
20 ending 6/30/14, you will see on the balance sheet that
21 there are shareholder loans of \$244,000. They're paid in
22 capital listed there of \$24,717 and the stock of \$43,522.
23 There are a lot of other entries there, but those I think
24 are the most germane, totaling \$312,551. I think I might
25 have misspoken. It might have been the very first return

1 that show that. The very first, 2000, that showed that
2 \$312,000.

3 Then if you were to going to a later exhibit,
4 Exhibit 15, which has the latest corporate return that we
5 have an ending balance sheet on, which would be the '13
6 corporate return ending 6/30/2014. You will see that
7 those same numbers went to shareholders loans of \$328,000
8 paid in capital, of \$173,000 and change, obviously, and
9 the stock, of course, is \$43,522, which never changed for
10 a total of \$545,720. So, again, it's the corporate
11 returns that are -- that are supporting that, not direct
12 items.

13 So the next three items, I would like to talk
14 about direct items that were in the exhibits. So
15 Exhibit 19 is a ledger, and that ledger has the year 2012
16 on it. And about 20 percent the way down, there's an
17 entry, shareholder loan \$100,000 debit to cash. This is
18 the example of some direct evidence that shows -- the book
19 showed the money was coming from the shareholder. And if
20 it wasn't the shareholder, it would someone good do --
21 do-gooder that was putting it in. So I believe it was
22 Don. Now, I know it was because I watched him do it in
23 the sense that I observed in real time his business losing
24 money. I observed the ledgers happening, and I observed
25 me preparing the corporate returns recording those items.

1 That's the extent that I can only verify. So that was
2 \$100,000.

3 The next one -- the next item is Exhibit 17,
4 which shows a check. It's about the fourth or fifth page
5 down on Exhibit 17, and there's a check written signed by
6 Don Weinstein for \$14,000 made to Photo Impact, Inc. Now,
7 it would be nice if we had \$700,000 of these checks. We
8 don't have those records. So we're cobbling together all
9 the records we do have to try and support this adjusted
10 basis. Also in Exhibit 17 there's a bank statement
11 showing \$100,000 deposit to Photo Impact. Now you'll
12 notice there that there's \$100,000 in and I think there's
13 \$56,000 out right below it.

14 So I ask Don about this; does he remember?
15 Because I certainly don't remember that. And he says,
16 yes, he does remember. And I'll let him comment
17 afterwards to confirm what I'm saying is true. Is that he
18 said, I had to payoff business credit cards, and I can't
19 remember why I had to take it out to do that. But in
20 order to get it done, they wanted it done that way. And
21 so I took a distribution of that -- of that part of
22 \$100,000 and then paid those corporate debts off. In any
23 case, he can comment on that.

24 And finally in Exhibit 17 also, you will find
25 four now called Tax and Fee Administration. It used to be

1 called the sales tax, the BOE, and there's four bills.
2 These four bills illustrate leftover expenses from Photo
3 Impact that were not able to be paid by Photo Impact when
4 we dissolved the corporation. Don assumed all debts. He
5 never claimed bankruptcy. The corporation never claimed
6 bankruptcy. The payroll tax, sales tax, and other debts
7 were taken care by him after it closed, which I believe
8 would add to the adjusted basis.

9 The above items I just mentioned total
10 approximately \$246,000, assuming we interpret the \$100,000
11 full, not 44 because 56 was taken out in one of those.
12 Those are, I believe, somewhat direct evidence as opposed
13 to more ancillary evidence of the corporate returns.

14 That ends my portion of the presentation. And so
15 I'd like -- of course, any questions or maybe you'd like
16 Don to make any comments or clarifications on anything
17 I've said.

18 JUDGE GAST: Yeah. Mr. Weinstein can continue to
19 make any further comments before we have questions. That
20 would be great.

21 MR. WEINSTEIN: So I think you've heard that what
22 Michael's gone through. And on -- on that, let's say they
23 take the money out on the \$56,000, those definitely were
24 to payoff corporate credit cards, corporate loans. And,
25 you know, because it was my company, and to me it -- it

1 didn't seem to make a difference of how it was paid as
2 long as it was paid.

3 A lot of the records were, you know, kept as long
4 as I can keep them. I had a storage area. When I sold
5 the building, I moved them in to -- and keep as much as I
6 could. I mean, I didn't think I needed to keep like a
7 warehouse full of, you know, records and invoices and
8 stuff because all of the tax returns were always put
9 through with no questions and no issues. The -- I guess
10 the difficult part of this is all -- everything that we're
11 talking about here is money I put into it and money that
12 I -- I lost, basically, trying to keep my company going.

13 So, but I -- like Mike said, I'm an optimist.
14 And thank God the money I put into it kept my business
15 going enough to where I could survive. And now, you know,
16 44 years later I'm still in business and still employing
17 people and still paying all my taxes and everything else.

18 So I'll answer any questions that anybody has.
19 Just let me know. Thank you.

20 JUDGE GAST: Thank you very much.

21 At this point, I'm going to ask FTB if they have
22 questions for the witnesses.

23 MS. WOODRUFF: We do not have any questions for
24 Mr. Weinstein.

25 JUDGE GAST: Okay. Thank you.

1 And I'm going to turn it over to my Panelists.

2 Judge Le, do you have any questions for the
3 witnesses or Appellants in general?

4 JUDGE LE: Yes. My first question is I want to
5 turn to the Wells Fargo Bank statement that you pointed
6 out. On the same day there was a \$100,000 transfer from
7 Weinstein to Photo Impact. If you look two lines down,
8 there was a check written on that same date of \$26,000.
9 Do you know who that check was made for?

10 MR. WEINSTEIN: I can answer that. That was a
11 Wells Fargo loan; basically, the balance of the loan.

12 JUDGE LE: Okay. Thank you. I do have another
13 question. Can you tell us more about the entities that
14 were involved with Photo Impact, Incorporation. Did they
15 own another entity, what the structure was like?

16 MR. WEINSTEIN: Can you explain that a little bit
17 clearer.

18 JUDGE LE: Yes. Did Photo Impact, Inc., own
19 another entity, like a partnership?

20 MR. WEINSTEIN: No.

21 MR. BERNSTEIN: May I add to it, just from the
22 tax standpoint as a preparer? There were no other
23 entities. He had the corporation. He owned the building.
24 He rented -- he did that from his personal return, and the
25 corporation paid him fair market value rent for that

1 building that he was in for a long time. There were no
2 other owners during the entire time, and he did not own
3 any other companies during that time. Nor did this
4 company own any other companies during that time.

5 JUDGE LE: Okay. Thank you. On the return --
6 let me just pull up the exhibit here. At, I believe,
7 Exhibit 16, Schedule E, it shows income from Photo Impact
8 LLC.

9 MR. BERNSTEIN: I think we have the Schedule E
10 showing here. Your question?

11 JUDGE LE: Yes. It shows an entity Photo Impact
12 LLC.

13 MR. BERNSTEIN: Maybe I'm not looking at the
14 same. I see a Schedule E. It says 931 North Citrus
15 Avenue.

16 JUDGE LE: Yup. And if you turn to the next
17 page, Part II Income Or Loss From Partnership.

18 MR. BERNSTEIN: Yeah. Photo Impact LLC. I don't
19 know if he created -- I'd have to look it up. It looks
20 like a partnership that he might have created. I might be
21 mistaken about that, that there was a minor partnership.
22 But it wasn't owned by Photo Impact. It was owned
23 personally. And would have to get more information for
24 the Judge to know what that item was.

25 JUDGE LE: Thank you. Let me turn to one more

1 thing here. In Exhibit 17, the check that you pointed out
2 your presentation, the check that was made to Photo
3 Impact, the \$14,000.

4 MR. BERNSTEIN: Yes.

5 JUDGE LE: It doesn't say Photo Impact, Inc. It
6 just says Photo Impact. I guess my question is, how do we
7 know that was made to Photo Impact, Inc., and not another
8 Photo Impact entity.

9 MR. BERNSTEIN: The year of that check, I would
10 have to produce the individual return showing that there
11 was no other entity. But as I often get checks to Michael
12 Bernstein instead of Bernstein Financial, people he does
13 business with get the right checks for Photo Impact, and
14 the bank will usually accept that, no problem.

15 Don, you want to make a comment about that?

16 MR. WEINSTEIN: Yeah. I mean, even though unless
17 they know my business is Photo Imaging LLC, people will
18 give me a check for Photo Impact, and then it gets
19 deposited.

20 JUDGE LE: Okay. Thank you. No further question
21 at this time.

22 JUDGE GAST: Thank you.

23 I'm going to ask, Judge Lam, do you have any
24 questions?

25 JUDGE LAM: No questions. Thank you.

1 JUDGE GAST: Okay. I do have a few just
2 background questions. So the transaction we're talking
3 about, was this a 331-A complete liquidation? I know FTB
4 is going to present, but I just wanted to throw that out
5 there because I didn't see anything in the briefing or
6 filings as to what transaction we're talking about. To me
7 that seems like what we're under.

8 I'll ask, Mr. Bernstein, does that make sense?

9 MR. BERNSTEIN: I believe so. I'm not -- I
10 didn't do the dissolution. I'm sure a lawyer did.

11 JUDGE GAST: Okay. Okay. No problem.

12 MR. BERNSTEIN: So I believe it was a dissolution
13 where there was no corporation anymore, and Don Weinstein
14 accepted all liability of that dissolution.

15 JUDGE GAST: Okay. And then my next question is,
16 you know, you talk about shareholder loans. My question
17 is, how does that increase basis? Or are you saying these
18 aren't true debt owed from the corporation to Weinstein,
19 it's really equity? Is that what you're saying?

20 MR. BERNSTEIN: Well, I believe both would --
21 yes. But I believe both would work. So if the loan was
22 not paid back, he would have a -- I believe a loss on that
23 loan, and it would be a loss. But when loans are not
24 serviced and not able to be serviced, most government
25 agency want to convert that into a capital contribution as

1 opposed to a loan because it's not being serviced. And I
2 believe most government agencies would prefer it to be a
3 capital contribution because then you can't pay it back to
4 yourself without a dividend.

5 So I understand that in a C corp. And so I tried
6 to post -- when he said I'm borrowing this money from
7 myself, I tried to post this as a loan. But when he was
8 unable to pay it back, I oftentimes converted it to
9 capital contribution because that's what it ended up
10 being. So at the very best with a loan, I believe that
11 the corporation who had a huge NOL would nearly have to
12 show the relief of debt into the corporation, and the
13 individual would then get a write-off of that loan, which
14 would be similar to a capital loss. That's the way I
15 viewed it.

16 JUDGE GAST: Okay. Thank you.

17 All right. I'm going to turn it over to FTB for
18 their presentation.

19 You will have 20 minutes, whenever you're ready.

20

21 PRESENTATION

22 MS. WOODRUFF: All right. Good morning, Panel
23 Members, and thank you for your time today. My name is
24 Sonia Woodruff, and with me today is Nathan Hall, and we
25 represent the Franchise Tax Board in this matter.

1 So the issue in this appeal is whether Appellants
2 have satisfied their burden of proof to claim a basis of
3 \$796,430 in the stock of their photo processing company,
4 which they sold in 2015. Appellants sold Photo Impact,
5 Inc., and reported a large capital loss on their 2015
6 individual income tax return.

7 Now, Appellants take the position that their
8 reported shareholder basis in Photo Impact was made up of
9 cash contributions as well as personal loans taken on
10 behalf of the corporation or loans to the corporation.
11 And the main issue with these claims is that Appellants
12 had not been able to supply documents reflecting the
13 actual transfers to the corporation or evidence that they
14 made loans that should be treated as capital
15 contributions. Now, just prior to prehearing conference
16 in this matter, Appellants submit several-hundred pages of
17 new documents and appear to be raising some new arguments.
18 But the new documents suffer from the same problem as
19 Appellants' earlier documents.

20 I'm going to focus today's presentation mostly on
21 the arguments -- on the new arguments and documents.
22 First, I'd like to give a brief summary of the relevant
23 law for the treatment of cash transfers to a C corporation
24 by a shareholder. Next, I'm going to address the three
25 main categories of amounts that Appellants claim make up

1 their basis: And those were the original stock
2 acquisition amount, loans from the shareholder, and then
3 additional contributions of capital.

4 So before I address Appellants new documents, I
5 would like to address the law regarding shareholder loans
6 and C corporation, generally. And as you heard here
7 today, Appellants made a deliberate choice to choose a
8 C corporation as their form of entity. So, generally, a
9 shareholder making loans to a C corporation is not going
10 to increase their basis in the stock of the corporation.
11 And this is in direct contrast to the subchapter S rules
12 related to S corporations for which there are specific
13 rules regarding debt base.

14 Even so, if a shareholder in a C corporation
15 actually transfers money to the corporation, it may be
16 considered a contribution to capital under IRC -- or
17 Internal Revenue Code section 118, which can be treated as
18 an increase in the cost of the stock to the individual
19 shareholder. But this rule should be contrasted with the
20 idea that making loans to a C corporation or paying its
21 debts will automatically increase the shareholder's basis
22 in the stock of the corporation. And it's actually a
23 factual question of whether a shareholder actually made a
24 capital contribution or a loan that may increase their
25 basis.

1 Under Internal Revenue Code section 385 and the
2 related case law, there are a number of factors to
3 consider in whether amounts transferred between a
4 shareholder and their corporation should be considered
5 debt or equity. In this case, we simply do not have
6 enough evidence even to attempt to apply those factors.
7 Appellants just have not shown that they transferred
8 approximately \$796,000 to their corporation and that it
9 should be treated as capital contributions.

10 During Respondent's audit and protest, Appellants
11 did submit copies of three canceled checks and five loan
12 statements. And the problem with these documents is that
13 they lacked sufficient detail to corroborate Appellants'
14 claimed basis. There were no details to show the checks
15 were payments on behalf of Photo Impact, Inc., or
16 transfers to Photo Impact, Inc., as the Appellants assert.
17 The loan statement provided an overview of account
18 activities, such as credit limit, credit and use, and
19 available credit, but they named Appellants personally and
20 provided no other details to show how these amounts were
21 paid or canceled -- or applied.

22 I'd now like to address Appellants' newly
23 submitted documents and arguments. Most of the documents
24 consist of Photo Impact, Inc.'s corporate tax returns, for
25 several years, dating back from the year 2000. They also

1 submitted copies from Photo Impact's general ledger, a
2 Wells Fargo account statement, and some other assorted
3 documents. So first, the corporate tax returns do not in
4 themselves substantiate Appellants' claimed stock basis.
5 They're not source documents but rather, they are Photo
6 Impact's reported amounts on tax returns. They cannot
7 show with clarity the amounts that were actually
8 transferred, when they were transferred, and that those
9 amounts should increase capital contributions.

10 Now, there are quite a few Tax Court decisions
11 that stand for the idea that claiming a deduction on an
12 income tax return is not sufficient to substantiate the
13 underlying expense, and that the income tax return is
14 merely a statement of the taxpayer's claim. It's not
15 presumed to be correct. And, unfortunately, these cases
16 were not included in the original briefing just because
17 Appellants did not provide Photo Impact's tax returns or
18 present arguments based on those returns until fairly
19 recently. So I would be happy to provide those additional
20 citations today if the Panel would like to consider them.
21 Or if you would prefer, I could submit them in some
22 post-hearing briefing as well.

23 But, similarly, unless corroborated by other
24 evidence, an entry on a taxpayer's books generally will
25 not suffice to substantiate an expense. So even though

1 the corporate returns are not enough on their own to
2 substantiate Appellants' claims, I did review all of the
3 available records to determine if we could, you know, tie
4 them to any other documents and, thereby, find some
5 support for Appellants' claims.

6 A review of the returns, however, revealed only
7 more discrepancies. So, for example, Appellants
8 maintained they contributed an initial amount of \$43,522
9 to Photo Impact, Inc. They haven't been able to show any
10 documents that would support that amount, such as original
11 stock certificates, some other kind of corporate records.
12 The corporate tax returns sporadically do not report this
13 original contribution amount. So, for example, on the
14 2011, 2012, and 2013 Forms 100 for Photo Impact, Inc., the
15 Schedule L shows no amount listed for the value of the
16 capital -- the original contribution. And you can see
17 that in Exhibit 12, page 6, Exhibit 13, page 5, and
18 Exhibit 14, page 6. Now, this may have been simply an
19 oversight. However, these documents are really the only
20 documents Appellants have been able to provide for their
21 initial stock contribution amounts, and they are not
22 consistent.

23 Second, Appellants argue they made loans to the
24 corporation and paid debts of corporation, and they wish
25 to include these amounts in their stock basis. As stated

1 earlier, there is no category of debt basis for a C
2 corporation shareholder. The shareholder making the loans
3 to the corporation would need to show that they were, in
4 effect, not loans but rather, contributions to capital.
5 And that could include evidence that the loans were
6 actually made and that they were later forgiven and that
7 the shareholder properly recorded them as a capital
8 contribution.

9 But here, Appellants have failed to even show
10 that they actually transferred those claimed loan amounts
11 to the corporation. So, for example, if you look to
12 Appellants' new Exhibit 18, page 16, you will see a page
13 from the 2012 general ledger. And that reflects \$100,000
14 of a loan from shareholder occurring on January 18th,
15 2012. The same 2012 general ledger reflects a number of
16 smaller shareholder loan amounts taking place in tax year
17 2020 -- 2012. However, when you look at the Form 100
18 Schedule L balance sheet for Photo Impact for the 2012 tax
19 year -- and that's Exhibit 13, page 5 -- you see that
20 shareholder loans actually decreased for that tax year
21 from to \$388,560 to \$351,607 by the end of that tax year.

22 So where did that purported \$100,000 loan amount
23 go? Was it paid back in the same year? We just don't
24 know. Similarly, Exhibit 18, page 1 of Appellants new
25 documents includes an accounting report labeled balance

1 sheet as of June 30th, 2012. The line item for
2 shareholder loan is \$102,735. Now, is amount supposed to
3 reflect all shareholder loans of that date? Or does
4 that amount reflect the alleged amounts loaned in 2012?
5 Which, by the way, do not appear in Photo Impact's
6 Schedule L balance sheet. So we just don't have
7 corroborating numbers here.

8 The new documents raise many more questions about
9 the share -- about the purported shareholder loans to
10 Photo Impact than they answer. They do not establish an
11 accurate amount for any shareholder loans to the
12 corporation, and they do not show that these alleged loans
13 should actually be treated as shareholder capital
14 contribution. Rather, the fact that Photo Impact's
15 Schedule L and the assorted ledgers label these amounts as
16 shareholder loans, suggest that they should be treated as
17 loans, rather than capital contributions. And it directly
18 contradicts their argument that they should increase stock
19 basis.

20 Now, Appellants also argue that they personally
21 paid debts of the corporation, including payroll and some
22 other liabilities, and that this payment should increase
23 their basis in Photo Impact, Inc. Again, the payment of
24 the corporation's debts cannot automatically increase
25 their stock basis in the C corporation. And it's

1 important to note that shareholders are not generally
2 liable for the debts of a corporation absent some
3 additional circumstances, such as a personal guarantee.
4 There's no evidence that Appellants personally guaranteed
5 the debts, and they have not argued that they guarantee
6 the debts of the corporation.

7 So this argument suffers from the same problem as
8 the other claimed amounts. If Appellants are arguing that
9 they paid debts of the corporation and that this action
10 should be treated as a contribution to capital, they've
11 not proved they actually paid the amounts, and they have
12 not shown that it should be treated as a capital
13 contribution. In fact, the balance sheets Appellants rely
14 on do not even reflect these additional amounts.

15 As for the last category of amounts Appellants
16 claim they paid in additional capital of \$311,172 to Photo
17 Impact, as with the other amounts, Appellants cannot show
18 the actual transfer of this figure to the corporation. A
19 review of the newly submitted documents reveals that the
20 additional paid in capital amount fluctuated over the
21 years. So we have an original amount of \$24,717 in 2004
22 that went up to \$380,959; and that's Exhibit 5, page 6.
23 That was adjusted down to \$180,776 in 2007. That's
24 Exhibit 8, page 6; and \$173,918 in 2011. That amount
25 jumped back up to \$311,172 in 2014. So there's little

1 explanation given for these adjusted amounts other than an
2 adjustment to books in tax year 2007. Because the
3 Schedule L amounts are not corroborated with other
4 records, Appellants may not use this amount to increase
5 their basis.

6 So to sum up, Appellants have failed to prove
7 basis claimed on their tax return for Photo Impact. While
8 they have submitted a number of new documents,
9 unfortunately, it's impossible to corroborate those
10 amounts detailed in Photo Impact's tax returns, and then
11 the general ledgers. Generally, deductions from gross
12 income are a matter of legislative grace, and the burden
13 is on the taxpayers to show by competent evidence that
14 they are entitled to claim the deductions. In this case,
15 we have very little evidence other than positions taken on
16 tax returns.

17 There's a general lack of the usual corporate
18 formality in recordkeeping that, you know, you might
19 expect with a C corporation, and that make it very
20 difficult to attempt to make a Cohan-type of estimation of
21 basis. Without any additional information, Respondent
22 request that the OTA affirm its assessment of additional
23 tax.

24 Thank you. And with that, I'm happy to answer
25 any additional questions you may have.

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JUDGE GAST: Thank you very much.

I'm going to turn it over to my Panelists for questions.

Judge Le?

JUDGE LE: No questions. Thank you.

MS. WOODRUFF: Thank you.

JUDGE GAST: And Judge Lam?

JUDGE LAM: No questions. Thank you.

JUDGE GAST: Okay. I just have one question for FTB. The bank statement from Photo Impact -- or of Photo Impact that covers the June 1st, 2015 to June 30th, 2015, period in Exhibit 17 -- excuse me -- why wouldn't Appellants get at least, say, net \$44,000 in basis?

MS. WOODRUFF: Yeah. So the 2015 ledger shows, I guess, net \$44,000 transferred to Photo Impact. However, we -- the amount that they have actually claimed as paid in capital, I believe is a \$311,000 amount that dates back to the 2014 tax return. So we just -- they haven't adjusted that amount for any \$44,000 contribution happening in 2015, if that makes sense.

JUDGE GAST: Thank you.

All right. With that, I'm going to turn it back over to the taxpayers for their rebuttal. You will have five minutes. Please begin whenever you're ready.

MR. BERNSTEIN: Okay. Thank you. I'll start,

1 and then let Don make a comment.

2

3

CLOSING STATEMENT

4 MR. BERNSTEIN: I'd like to address a couple of
5 the items that Franchise Tax Board brought up. I feel
6 that Franchise Tax Board wants to have it both ways. If
7 there was a loan made for \$100,000 and the no note, no
8 payments on interest, they would be the first ones to
9 convert that to capital contribution because they'd want
10 any payments back to be a dividend and not a loan
11 repayment. Yet, here they take the other position, the
12 other side, saying, no, it's a loan.

13 So I understand the law, and I understand that
14 Photo Impact was suffering, and they're a small
15 corporation with one owner during this time. So I would
16 love for all the books and records to be super clean like
17 the Franchise Tax Board wants them. We have to keep in
18 mind that Don Weinstein as sole proprietor did very well
19 for five years from '80 to '85. He did very well from '85
20 until about '95, and then there was this problem.

21 As far as the recording of the entries, we have
22 bookkeepers that work for Don that are recording these
23 entries in a ledger. Anyone who has taken ledgers from a
24 third -- from a client and tried to then convert it to the
25 right entries for a corporate return has come across this

1 many times. Is it loan? Is it capital contribution? Do
2 you have a note? Are you going to service it? So there
3 were many movements on the balance sheet to try and
4 reflect the proper way to address this, and he -- as he
5 didn't service loans. I said you have a capital
6 contribution because it wasn't really a loan. I don't
7 believe that loan need be forgiven because it wasn't a
8 loan to begin with, and none of them ended up being loans
9 to begin with. So I maintain that they're all capital
10 contributions.

11 As far as the \$43,522, the Franchise Tax Board
12 reverted it as a cash contribution for the original stock,
13 and I think that's direct -- directly incorrect based on
14 my description earlier that there were assets, photo
15 equipment, transferred into the corporation upon the
16 creation of the corporation, which created probably
17 three-fourths of that adjusted basis.

18 For the years in which case a stock line was
19 missed, it was inadvertent. It was put in back in. It
20 was probably inadvertently put in under capital
21 contribution, but the balance sheets balanced every year,
22 and the money was put in.

23 That's all. Thank you.

24 JUDGE GAST: Okay. I'm going to turn it over to
25 my Panel.

1 Oh, I'm sorry. Mr. Weinstein.

2 MR. WEINSTEIN: No. I just wanted to say that,
3 you know, I did the best I could. And I took an oath at
4 this meeting, and I just want to say that every bit of
5 money that went in there that I put in, was put in. And I
6 apologize if the records weren't as good as they should
7 have been. Maybe I should have kept them longer, but as a
8 sole small business, you know, I did the best I could.
9 And based on my conversation earlier of what my industry
10 has done, you know, thank God I'm still going and still a
11 viable company.

12 Thank you.

13 JUDGE GAST: Thank you both for your
14 presentations.

15 I'm going to turn it over to my Panel one last
16 time.

17 Judge Le, do you have any final questions?

18 JUDGE LE: Maybe just one final question. The
19 FTB discussed how the shareholders are not generally
20 liable for the debts of the corporation. I guess my
21 question to Appellant is, can you explain why you
22 personally paid the debt of the corporation here.

23 MR. BERNSTEIN: Don, maybe you could start with
24 sales tax and then go to the payroll tax and any other
25 items.

1 MR. WEINSTEIN: There -- when the company was
2 closed and I sold the building, and I took money
3 immediately out of the sale of the building to pay for
4 these -- this debt. I just didn't write it off or go
5 bankrupt. I felt it was my responsibility to any debt
6 that was created with my company, I paid off. Now, I
7 guess it would have been easier looking back on this,
8 based on this, you know what we're going through right
9 now, that all money should have been put into the Photo
10 Impact and paid through that and kept all kinds of
11 records. To me, you know, Photo Impact, even though it
12 was a C corp, and me are one company.

13 MR. BERNSTEIN: May I add to that?

14 JUDGE LE: Yes, go ahead.

15 MR. BERNSTEIN: Thank you. And it wasn't as if
16 people weren't approaching him to get the money. So this
17 BOE said you know owe sales tax. You need to pay it. The
18 IRS and Fran -- and EDD said you owe payroll tax left
19 over. You need to pay it. So he paid it. Those are some
20 of the government agencies.

21 Thank you.

22 JUDGE LE: Thank you. No further questions.

23 JUDGE GAST: And I'm going ask Judge Lam, do you
24 have any further questions?

25 JUDGE LAM: No questions. Thank you.

1 JUDGE GAST: Okay. I don't have any questions
2 myself. I want to thank the parties for their
3 presentations. This concludes the hearing, and we will
4 meet -- the Panel will meet and decide the case based on
5 the arguments, documents, and testimony presented. We
6 will issue our written decision no later than 100 days
7 from today.

8 The case is submitted and the record is closed,
9 and this is the last hearing --

10 JUDGE LE: Can we discuss privately for a few
11 minutes before we close the record here?

12 JUDGE GAST: Sure. We'll take a five-minute
13 recess.

14 Thank you.

15 (There is a pause in the proceedings.)

16 JUDGE GAST: Yes. We'll go back on the record.

17 I want to give Ms. Woodruff an opportunity to
18 read into the record her support, her citations, but then
19 I think we'll close the record. And if the Panel would
20 like additional briefing, we can reopen the record.

21 Does that sound okay?

22 MS. WOODRUFF: Yes. Thank you.

23 JUDGE GAST: Okay. Please proceed.

24 MS. WOODRUFF: Okay. So there's Wilkinson v
25 Commissioner, and that's 71 TC 633 1979. There's

1 Isaics v Commissioner TC memo 2015-121,
2 Roberts v commissioner 62 TC at 837. And those are all
3 citations for tax returns being insufficient to prove the
4 facts reported. Then there's also some law stating that
5 ledgers alone cannot substantiate deductions,
6 Olive v Commissioner. That's 139 TC 19 2012,
7 O'Hannah v Commissioner TC Memo 2014-83, and
8 Lestman v Commissioner TC Memo 1960-116.

9 I believe that's it. Yeah. Those are the
10 citations that I wanted to admit into the record. So
11 thank you.

12 JUDGE GAST: Thank you.

13 Ms. Alonzo, were you able to get those?

14 THE STENOGRAPHER: Yes. Thank you.

15 JUDGE GAST: Okay. Is there anything else before
16 I conclude the hearing?

17 MS. WOODRUFF: No.

18 MR. BERNSTEIN: I would just give a final
19 statement saying that perhaps each of those items
20 separately may not be sufficient. We maintain that all of
21 them together are sufficient, including the testimony.

22 JUDGE GAST: Okay. Thank you, Mr. Bernstein.

23 Okay. With that, I'm going to conclude the
24 hearing. Again, thank the parties for their
25 presentations. As I mentioned, we will meet and decide

1 the case based on the arguments, documents, and testimony
2 presented, and we will issue our written opinion no later
3 than 100 days from today.

4 The case is submitted and the record is now
5 closed.

6 And this is the last hearing for today.

7 Thank you.

8 (Proceedings adjourned at 10:40 a.m.)

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I, Ernalyne 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 19th day of April, 2024.

ERNALYN M. ALONZO
HEARING REPORTER