OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 220510291
KING SOLARMAN, INC.	

OPINION

Representing the Parties:

For Appellant:	Steven R. Mather, Attorney
For Respondent:	Desiree Macedo, Attorney Jaclyn Zumaeta, Attorney
For Office of Tax Appeals:	Nguyen Dang, Attorney

H. LE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, King Solarman, Inc. (appellant) appeals an action of the Franchise Tax Board (respondent) proposing additional tax of $501,156, plus applicable interest, for appellant's fiscal year ended April 30, 2015 (FYE 2015).[1]

Office of Tax Appeals (OTA) Administrative Law Judges Huy "Mike" Le, Richard Tay, and Amanda Vassigh held an oral hearing for this matter in Cerritos, California, on December 6, 2023. At the conclusion of the hearing, OTA closed the record and submitted this matter for an opinion.

ISSUES

1. Whether the statute of limitations bars respondent's proposed assessment.
2. Whether appellant has established error in respondent's proposed assessment, which is based on a federal determination.

[1] Appellant made no specific arguments regarding interest. Thus, OTA will not discuss it further.

FACTUAL FINDINGS

1. Appellant, a corporation incorporated and headquartered in California, was a wholesaler of mobile solar-powered lighting units (solar towers), which are commonly used to provide lighting for parking lots, construction sites, and remote work locations.
2. Appellant executed an agreement in FYE 2015 to sell 162 solar towers for $7,938,000 (Sale).
3. The Sale agreement specified that appellant would receive two cash payments totaling $2,143,260 and a 20-year promissory note for the $5,794,740 remaining balance, which would be paid in 240 monthly payments of $31,388.50.
4. During FYE 2015, appellant received the two cash payments and four monthly payments on the note totaling $2,268,814 ($2,143,260 + (4 x $31,388.50)), which appellant reported on its federal and state income tax returns for that year.
5. Appellant did not report the $5,669,186 ($7,938,000 - $2,268,814) remaining balance due from the Sale.
6. On July 14, 2015, appellant filed its FYE 2015 California Corporation Franchise or Income Tax Return.
7. Appellant elected the accrual method of accounting on both its federal and California income tax returns for FYE 2015. The Schedule L Balance Sheets on the federal and California tax returns have an entry for "accounts payable."
8. The IRS audited appellant's federal corporation income tax return and determined that appellant must use an inventory under Internal Revenue Code (IRC) section 471, which in turn required appellant to use the accrual method of accounting pursuant to Treasury Regulation section 1.446-1(c)(2)(i).[2] Utilizing this accounting method, the IRS determined that appellant must recognize the entire $7,938,000 Sale amount in FYE 2015.
9. The IRS issued a notice of deficiency to appellant, which appellant petitioned to the U.S. Tax Court.

[2] IRC sections 446 and 471 grant the IRS broad discretion to require taxpayers to take inventories and to use an accounting method which, in its opinion, clearly reflects income. (*Hamilton Industries, Inc. v Commissioner* (1991) 97 T.C. 120, 128.) Pursuant to this grant of authority, the IRS promulgated Treasury Regulation section 1.446-1(c)(2)(i), which generally requires that in "any case in which it is necessary to use an inventory[,] the accrual method of accounting must be used with regard to purchases and sales . . . "

10. In response to the petition, the IRS argued that in addition to Treasury Regulation section 1.446-1(c)(2)(i), IRC section 446(e) also required appellant to use the accrual method of accounting because appellant had elected to do so and did not obtain permission from the IRS to change that method of accounting.[3]

11. The U.S. Tax Court held, as pertinent here, the following: (1) that appellant used the accrual method of accounting, consistent with its explicit election to that effect on the return it filed for its first taxable year and subsequent taxable years; (2) that appellant was required to account for inventories under IRC section 471 and thus appellant was required to use the accrual method of accounting pursuant to Treasury Regulation section 1.446-1(c)(2)(i); and (3) that appellant did not qualify for the small business exception to this requirement provided for in IRS Revenue Procedure 2002-28, 2002-18 I.R.B. 815 (Revenue Procedure 2002-28).[4]

12. Appellant appealed to the Court of Appeals for the Ninth Circuit (Ninth Circuit). On December 11, 2020, the Ninth Circuit affirmed the U.S. Tax Court's holding that appellant needed to account for inventory under IRC section 471 and use the accrual method of accounting pursuant to Treasury Regulation section 1.446-1(c)(2)(i), and that appellant did not qualify for the small business exception provided for in Revenue Procedure 2002-28.[5] Therefore, appellant was required to include the $5,669,186 remaining balance due from the sale in its FYE 2015 return.

13. Appellant's IRS Account Transcript for FYE 2015 noted the following: Code 300, Additional tax assessed by examination – quick assessment, 03-27-2020.

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[3] IRC section 446(e) requires that taxpayers obtain the consent of the IRS prior to changing their method of accounting for purposes of computing taxable income. Where the IRS does not consent to such a change, the taxpayer is required to continue computing taxable income using the old method of accounting. (*Capital One Financial Corp. and Subsidiaries v. Commissioner* (2008) 130 T.C. 147, 155.)

[4] Revenue Procedure 2002-28 states in relevant part: "In order to reduce the administrative and tax compliance burdens on certain small business taxpayers and to minimize disputes between the Internal Revenue Service and small business taxpayers regarding the requirement to use an accrual method of accounting . . . because of the requirement to account for inventories . . . this revenue procedure provides that the Commissioner of Internal Revenue will exercise [its] discretion to except a qualifying small business taxpayer … from the requirements to use an accrual method of accounting under [IRC] § 446 and to account for inventories under § 471."

[5] The Ninth Circuit also noted that since appellant's susceptibility to inventory required it to use the accrual method, there was no need to decide whether appellant's prior selection of the accrual method check box on its tax forms also means the accrual method was required.

14. Neither appellant nor the IRS notified respondent of the assessment of the IRS deficiency determination.

15. After respondent independently discovered the assessment, it issued a Notice of Proposed Assessment (NPA) on May 19, 2021, to appellant increasing its net income by $5,669,186.

16. Appellant protested the NPA, and respondent issued a Notice of Action affirming its proposed assessment. This timely appeal followed.

DISCUSSION

Issue 1: Whether the statute of limitations bars respondent's proposed assessment.

If the IRS makes a change or correction to "any item required to be shown on a federal tax return, including any gross income, deduction, penalty, credit, or tax for any year," the taxpayer shall report the federal change to respondent within six months after the date of each final federal determination. (R&TC, § 18622(a).) If the taxpayer or the IRS reports the change or correction within six months after the final federal determination, respondent may issue an NPA resulting from those adjustments within two years from the date of the notice. (R&TC, § 19059(a).) If the taxpayer or the IRS reports that change or correction after the six-month period, respondent may issue an NPA resulting from those adjustments within four years from the date of the notification. (R&TC, § 19060(b).) R&TC section 19060(a) provides that if the taxpayer fails to notify respondent of the federal changes, then respondent may issue a proposed assessment at any time. The specific statute of limitations set forth in R&TC section 19060 overrides the general statute of limitations in R&TC section 19057.[6] (*Appeal of Valenti*, 2021-OTA-093P, citing *Ordlock v. Franchise Tax Bd*. (2006) 38 Cal.4th 897.)

The date of each final federal determination shall be the date on which each adjustment or resolution resulting from an IRS examination is assessed pursuant to IRC section 6203. (R&TC, § 18622(d).) IRC section 6203 provides that an assessment "shall be made by recording the liability of the taxpayer." Here, the IRS assessed and recorded a tax deficiency against appellant for FYE 2015 on March 27, 2020, as indicated on appellant's IRS Account Transcript

[6] The general statute of limitations pursuant to R&TC section 19057(a) would have required respondent to mail its NPA to appellant within four years after the return was filed.

with the following details: Code 300, Additional tax assessed by examination – quick assessment, 03-27-2020.[7] Thus, the date of the final federal determination is March 27, 2020.

Appellant appears to argue that the final federal determination occurred when the Ninth Circuit issued its opinion on December 11, 2020. California Code of Regulations, title 18, (Regulation) section 19059 suggests that the date of the final federal determination could be when the right to appeal the Ninth Circuit's opinion has expired:

> "A final determination is an irrevocable determination or adjustment of a taxpayer's federal tax liability from which there exists no further right of appeal either administrative or judicial. For example: . . . (2) The 90-day deficiency notice . . . is a final determination, unless a timely petition to redetermine the deficiency is filed in the Tax Court of the United States, in which event the judgment of the court of last resort affirming the deficiency, or the redetermination of the deficiency pursuant to a judgment of the court of last resort is the final determination. But the determination does not become final until the time for petitioning for a rehearing or appealing to a higher court has expired."

(Cal. Code Regs., tit. 18, § 19059.) However, the definition of the date of "final determination" in Regulation section 19059 has been superseded by the 1999 amendment to R&TC section 18622, which added subsection (d) and states that the date of each final federal determination shall be when an IRS examination is assessed. (Sen. Bill No. 1229 (1999–2000 Reg. Sess.) § 56; see also FTB Notice 99-9 ["The definition of the date of 'final determination' in 18 Cal. Code Regs. section 19059 has been superseded and no longer applies to determinations assessed on or after January 1, 2000"].)

Since the date of the final federal determination is March 27, 2020, appellant was required to report the federal change or correction to respondent within six months of this date, pursuant to R&TC section 18622. Appellant did not do so. In fact, nothing in the record indicates that appellant or the IRS notified respondent of the final federal determination at any time. Because of this, respondent may mail the NPA at any time. (R&TC, § 19060(a).) Thus, after respondent independently discovered the federal assessment, it timely issued the NPA on May 19, 2021, within the statute of limitations.

[7] Although the record does not contain specific information on why the IRS made a quick assessment before the Ninth Circuit issued its opinion, appellant's IRS Account Transcript has an entry for "bankruptcy or other legal action filed" in 2017.

Appellant also argues that respondent's proposed assessment was not the result of a federal adjustment but instead is "materially different" than the federal adjustment. OTA disagrees. The federal adjustment referred to by R&TC sections 18622, 19059, and 19060 is a change or correction by the IRS. Here, the tax deficiency assessed by the IRS was based on the $5,669,186 unreported Sale amount appellant was required to recognize using the accrual method of accounting. Respondent's NPA proposes to increase appellant's net income by this same amount and for the same reasons as the IRS. This shows that respondent's proposed assessment was based on the federal adjustment.

Accordingly, respondent issued the NPA resulting from the federal adjustment within the applicable statute of limitations.

Issue 2: Whether appellant has established error in respondent's proposed assessment, which is based on a federal determination.

R&TC section 18622(a) provides that a taxpayer shall either concede the accuracy of a final federal determination or state wherein it is erroneous. Although respondent may base its proposed assessment on a final federal determination to the extent applicable under California law, it is not bound to do so and can conduct an independent investigation. (*Appeal of Black*, 2023-OTA-023P.) Likewise, appellant can establish respondent's proposed assessment based on a final federal determination is incorrect. (*Ibid*.) Appellant argues respondent's proposed assessment based on a final federal determination is incorrect for two reasons. First, appellant asserts that California does not conform to the federal law relating to the federal adjustment made in this case. Second, appellant contends that it elected and used the cash method, despite the U.S. Tax Court's findings to the contrary. OTA will address each argument.

California conformity to applicable federal law relating to method of accounting

Appellant argues that California does not conform to the federal law relating to the adjustment made in this case. Appellant asserts that the federal adjustment in this case was solely based on the Ninth Circuit's holding that appellant did not qualify for the small business exception to Treasury Regulation section 1.446-1(c)(2)(i), as set forth in Revenue Procedure 2002-28. Appellant further contends that subsequent changes to IRC section 471(c) in 2017 resulted in a new exemption provision under which appellant would not be required to use the

accrual method of accounting. Appellant urges that this new exemption should be retroactively applied here because the California legislature expressly adopted those changes. OTA disagrees.

Under federal tax provisions,[8] "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes [its] income in keeping [its] books." (IRC, § 446(a).) Among the permissible methods of accounting are the cash receipts and disbursements method (cash method) and the accrual method. (IRC, § 446(c).) Under the cash method, the taxpayer is generally required to recognize income in the year of receipt. (Treas. Reg. § 1.446-1(c)(1)(i).) Under the accrual method, the taxpayer is generally required to recognize income when "all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy." (Treas. Reg. § 1.446-1(c)(1)(ii).)

"In any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales," unless otherwise authorized by the IRS. (Treas. Reg. § 1.446-1(c)(2)(i).) A taxpayer must generally account for inventories in every case in which the production, purchase, or sale of merchandise is an income-producing factor. (IRC, § 471; Treas. Reg. § 1.471-1.)

In Revenue Procedure 2002-28,[9] the IRS announced that it would except qualifying small business taxpayer from the requirements to use an accrual method of accounting under IRC section 446 and to account for inventories under IRC section 471 if the taxpayer meets one of three tests: (1) its principal business activity is described in a North American Industry Classification System code other than one of the listed ineligible codes; (2) its principal business activity is the provision of services; or (3) its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications.

As pertinent here, the U.S. Tax Court held, and the Ninth Circuit affirmed, that appellant was required to use the accrual method of accounting pursuant to Treasury Regulation

[8] For taxable years beginning on or after January 1, 2010, and on or before December 31, 2014, R&TC sections 23051.5 and 17024.5(a)(1)(O) provides that for Corporation Tax Law purposes, California conforms to the IRC as of a January 1, 2009. Thus, references herein to the IRC and Treasury Regulations are to the version in effect on January 1, 2009.

[9] Revenue Procedure 2002-28 became obsolete for taxable years beginning after December 31, 2017. (See Rev. Proc. 2018-40, 2018-34 I.R.B. 320.)

section 1.446-1(c)(2)(i) because it needed to account for inventory as defined under IRC section 471. Furthermore, appellant did not qualify for the small business exception provided for in Revenue Procedure 2002-28.

This federal determination resulted in a California tax deficiency because California conforms to the applicable federal tax provisions. Here, the legal basis for the federal adjustment was IRC sections 446 and 471 and Treasury Regulation section 1.446-1(c)(2)(i). R&TC section 24651 is virtually identical to IRC section 446,[10] and thus federal rulings and Treasury Regulations are persuasive authority. (*J. H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, 985 ["In instances where federal law and California law are the same . . . rulings and [treasury] regulations dealing with the IRC are persuasive authority in interpreting the California statute"]; *Appeal of Akhtar*, 2021-OTA-118P ["there is a 'strong public policy favorable to interpreting' state tax statutes that are based upon federal statutes consistent with the interpretations of their federal analogs"].) California also expressly conforms, with some modification, to IRC section 471 at R&TC section 24701. In addition, where, as here, respondent has not promulgated any regulations pertaining to a provision of the Corporation Tax Law and the state statute conforms to the IRC, Treasury Regulations (here, Treas. Reg. § 1.446-1(c)(2)(i)) shall, insofar as possible, govern the interpretation of the conforming state statute. (Cal. Code Regs., tit. 18, § 19503; R&TC, § 23051.5(d).)

Appellant's contention that the federal adjustment was solely based on Revenue Procedure 2002-28 is without merit. Appellant ignores the fact that the Ninth Circuit also held that appellant must use the accrual method of accounting because appellant needed to account for inventory pursuant to IRC sections 446 and 471 and Treasury Regulation section 1.446-1(c)(2)(i), and that this holding was the reason for why appellant was required to include the entire Sale amount in income for FYE 2015. (*King Solarman, Inc. v. Commissioner* (9th Cir. 2020) 840 Fed.Appx. 74. [appellant was "restricted to the accrual method because 'it [wa]s necessary [for appellant] to use an inventory' and it did not receive permission from the [IRS] to use a different method"].) Moreover, it was appellant's failure to establish that it qualified for the exception set forth in Revenue Procedure 2002-28, and not the applicability of

[10] Instead of referring to the "Secretary," R&TC section 24651 refers to the "Franchise Tax Board" and has other non-substantive differences.

the revenue procedure itself (which is plainly an exception provision), that resulted in the federal adjustment.

Appellant's argument that the 2017 version of IRC section 471(c) should be retroactively applied is also unpersuasive. The new exemption provision provided for by that statute is effective for tax years beginning December 31, 2017, and therefore it is inapplicable to FYE 2015. (*King Solarman, Inc. v. Commissioner*, T.C. Memo. 2019-103, fn. 6.) Further, California's IRC conformity date for FYE 2015 was January 1, 2009. (R&TC, §§ 23051.5, 17024.5.) Therefore, despite appellant's assertion to the contrary, California does not conform to the 2017 changes to IRC section 471(c) for FYE 2015.

Based on the foregoing, OTA finds that California conforms to applicable federal law relating to method of accounting.

Method of accounting election

"A taxpayer filing [its] first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return." (Treas. Reg. § 1.446-1(e).) However, the taxpayer must secure the consent of respondent or the IRS before changing the method of accounting. (IRC, § 446(e); R&TC, § 24651(e).)

Appellant argues that it elected and used the cash method of accounting. However, on appellant's California and federal FYE 2015 returns, appellant checked the box for the accrual method of accounting. Although the record does not contain appellant's first return, the U.S. Tax Court noted that appellant explicitly elected the accrual method of accounting on its federal return for FYE 2012, the return filed for its first taxable year. In addition, appellant has not submitted evidence to prove that it actually used the cash method of accounting, such as its bookkeeping records. On the contrary, the evidence in the record suggests otherwise. The Schedule L Balance Sheets on the California and federal returns have an entry for "accounts payable," and this entry is consistent with the use of the accrual method of accounting. Appellant contends that its return preparer inadvertently checked the box for the accrual method of accounting, but appellant has not provided evidentiary support for this contention. Also, there is no evidence to suggest that appellant secured the consent of respondent or the IRS to use the cash method of accounting. Thus, OTA finds that appellant has not proven that it elected and used the cash method of accounting.

HOLDINGS

1. The statute of limitations does not bar respondent's proposed assessment.
2. Appellant has not established error in respondent's proposed assessment, which is based on a federal determination.

DISPOSITION

Respondent's action is sustained.

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Huy "Mike" Le
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Administrative Law Judge

We concur:

DocuSigned by:
F8E81582726F448...
Richard Tay
Administrative Law Judge

DocuSigned by:
Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

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