

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:)
S & I CONSTRUCTION, INC.) OTA Case No. 18093713
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OPINION

Representing the Parties:

For Appellant: Erez Solomon, EA
For Franchise Tax Board: D’Arcy Dewey, Attorney
For Office of Tax Appeals: Grant S. Thompson, Attorney

R. TAY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S & I Construction, Inc. (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$885,198 for the 2010 tax year.¹

Office of Tax Appeals (OTA) Administrative Law Judges Ovsep Akopchikyan, Asaf Kletter, and Richard Tay held an oral hearing for this matter in Cerritos, California, on August 8, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

ISSUE

Whether appellant has shown it is entitled a deduction for additional cost of goods sold (COGS) or subcontractor expense deductions in excess of those allowed by FTB.²

¹ FTB’s Notice of Action (NOA) does not include interest, however it notes that interest will be assessed. On appeal, FTB has allowed additional expenses and reduced its proposed assessment of additional tax to \$806,481. Also, appellant is no longer contesting various disallowed expenses, so the tax amount remaining at issue is less than \$806,481.

² The parties agree that this is the sole issue still in dispute. All other issues discussed prior to the hearing have been resolved and will not be discussed further.

FACTUAL FINDINGS

Appellant's Business

1. According to appellant, it is an intermediate company that “find[s] the right client, the right subcontractor and provid[es] the right cash flow in order to complete the [construction] project.” Appellant states that it receives a five percent commission and “provide[s] [c]ash for contractors so they can finish their projects.”

Appellant's 2010 California Tax Return

2. On its 2010 California tax return, appellant reported gross receipts of \$29,109,819 and COGS of \$27,340,218. Appellant subtracted \$1,597,171 of claimed business expense deductions, resulting in reported net income of \$172,432 and total tax of \$15,243. Appellant's reported COGS of \$27,340,218 primarily consisted of \$23,977,446 in job materials and \$3,111,361 paid to subcontractors.

FTB's Audit

3. FTB initiated an audit of appellant's 2010 California tax return.
4. On October 11, 2012, FTB issued its first information document request (IDR), in which it requested to review documents such as income statements, trial balance sheets and general ledgers. Appellant also requested and received extensions of time to provide documentation in response to the IDR. During the audit, an FTB auditor conducted an office visit and reviewed appellant's general ledger; however, appellant's general ledger lacked corroborating documentation and did not provide information about the recipient of reported payments, reported payments to cash or to itself, and reported transactions in round numbers.
5. On March 20, 2013, after FTB issued several IDRs and granted three extensions of time for appellant to locate available documentation, appellant called FTB and indicated it was having trouble finding documentation because its records had been stolen by former employees who were now working in the same line of business. FTB provided additional opportunities for appellant to obtain alternative documentation from subcontractors or other sources and conducted an extensive examination in which it met with appellant's representative many times and issued numerous IDRs. As a result, FTB reconstructed

appellant's financial information based on available information, including an examination of transactions in 14 bank accounts controlled by appellant and reviewing thousands of pages of documents such as bank statements and checks.

6. Based on an analysis of deposits into appellant's bank accounts, as adjusted for non-revenue transfers (such as transfers between appellant's bank accounts), FTB reduced appellant's gross receipts by \$6,307,422 (from \$29,109,819 to \$22,802,397).³ Appellant does not dispute this adjustment.
7. FTB determined that appellant could not have any COGS because it did not hold goods for sale or maintain any inventory. However, FTB determined that a portion of appellant's reported COGS are deductible as business expenses.
8. FTB asserts it was difficult to determine the amount of appellant's expenses because appellant did not provide cleared checks showing expenses, and its general ledger generally did not show specific payees (other than "cash" or payments to itself).⁴ To assist in its evaluation of expense invoices initially provided by appellant (Initial Invoices), FTB examined appellant's client revenue checks for January through April 2010, compared them to Initial Invoices for the same period, and determined that appellant had an expense-to-income ratio of 95 percent.⁵ However, the sum of appellant's client revenue checks accounted for only about 83 percent of appellant's gross receipts as determined by FTB for the same period.
9. FTB states that this sampling method was one way it checked the veracity of the Initial Invoices provided by appellant; however, it states that the invoices do not show "whether payments were made, who made the payments, or when the payments were made." Moreover, FTB indicates that approximately \$280,000 of checks were deposited into bank accounts that were not identified as appellant's banks accounts and some checks lacked information identifying the bank accounts into which they were deposited. Notwithstanding, after reviewing 1,480 Initial Invoices allegedly issued by

³ On appeal, FTB increased the amount of gross receipts by \$52,343.

⁴ In addition, appellant did not properly report payments on Forms 1099. It provided 58 handwritten Forms 1099-Misc, however FTB found that only one such Form 1099 was actually issued and filed.

⁵ FTB determined that the checks totaled approximately \$5.1 million, and the invoices totaled approximately \$4.8 million (i.e., approximately five percent less than the checks).

subcontractors, FTB allowed a total of \$12,860,449 of subcontractor expenses, which is approximately 95 percent of the client revenue checks verified by the Initial Invoices. FTB initially disallowed \$1,050,703 of claimed expenses that it determined constituted loan repayments. However, as noted below, FTB ultimately allowed the \$1,050,703 of claimed expenses. FTB also allowed \$806,671 of other expenses, including some expenses that appellant had not claimed.

10. Later in the audit, appellant provided additional documents including invoices purportedly received from subcontractors and invoices purportedly issued to subcontractors (Later Invoices). However, it is undisputed that the Later Invoices were created during the audit. The Later Invoices differ from the Initial Invoices. Generally, a subcontractor's Later Invoice to appellant is dated the same date as, and reflects the same total amount as, appellant's Later Invoice to the subcontractor and checks issued by the subcontractor to appellant.⁶ Unlike the Initial Invoices from subcontractors, the Later Invoices generally include a line item charging appellant five percent of the other amounts invoiced.⁷

Protest and Appeal

11. On April 4, 2016, FTB issued a Notice of Proposed Assessment (NPA) reflecting its reduction in appellant's gross income, its removal of appellant's claimed COGS and its adjustments to appellant's claimed expenses.
12. On August 1, 2018, FTB issued an NOA affirming its NPA, and appellant timely filed this appeal.⁸

Appellant's Additional Documentation

13. During the audit, and also during protest and appeal, appellant argued that it had over 25 boxes of additional documentation that FTB had not reviewed. FTB states that

⁶ For example, one of the Later Invoices is dated January 6, 2010, and purports to be from a remodeling company requesting that appellant pay it \$7,367.43, and another Later Invoice from appellant bills the subcontractor for \$7,367.43 on the same date. Also, the record includes a copy of a check from the same remodeling company to appellant written on the same date for the same amount.

⁷ It is not clear from the record why appellant's subcontractors would charge appellant a five percent amount when, at least according to appellant, it receives a five percent commission under its business model.

⁸ At the request of the parties, appeal proceedings were deferred over 10 months while they sought to resolve the appeal.

appellant represented that the boxes were similar to the sample of Later Invoices reviewed by its auditor, which FTB viewed as unreliable because they were created during the audit; they appeared to be invoices billing appellant's customers that were recast as invoices billing appellant; and, contrary to appellant's claims, they did not appear to be generated by third party contractors. In response, appellant states that the additional documentation is not similar to the Later Invoices that FTB deemed unreliable and is instead "exactly like" the Initial Invoices and proves that its subcontractor expenses equaled 95 percent of its gross receipts.

14. OTA requested additional briefing from the parties requesting that appellant submit a sample of the additional 25 boxes: specifically, only those portions of the documents that relate to the months of February, May, August, and October of 2010.⁹
15. In response, appellant states that, due to the volume of documents, it was providing invoices for "a few" of the clients for the first week of February 2010, the second week of May 2010, the third week of August 2010, and the fourth week of October 2010. Appellant states that the check copies it provided were not reconstructed and were from the bank. However, appellant states that the invoices from it were all "created during the audit by [it] per FTB instructions." As to invoices from clients, appellant states that many of the clients "also did not have organized accounting[,] that appellant requested invoices from its clients during the audit, and that it is possible that a few of the clients "also reconstructed their invoices." Appellant's response included more than a thousand pages of documents.
16. On review, the documents generally consisted of a copy of the check from a subcontractor to appellant, a purported invoice from the subcontractor to appellant, and another purported invoice from appellant to the subcontractor. Generally, both of the invoices, and the check, bear the same date, and are for the same total amount. For example, the response includes a copy of a deposited check from a subcontractor for \$100 dated February 1, 2010, an invoice from appellant to the subcontractor dated the same date and in the same amount, and an invoice from the subcontractor to appellant that is also dated the same date and in the same amount. Like the Later Invoices, the

⁹ OTA noted that FTB declined to suggest or accept a sampling methodology and further noted that a panel of administrative law judges (ALJs) or a lead ALJ would decide whether to accept any further additional evidence.

invoices to appellant have a format that is generally similar to one another, even though they were purportedly issued or created by many different subcontractors, and have a format that is similar to appellant's invoices to subcontractors. Also, for reasons that are unclear, the Later Invoices to appellant generally include five percent charge to appellant, and the Later Invoices from appellant also reflect a five percent commission to be received by appellant.

17. FTB's analysis indicates that the revenue checks appellant provided totaled approximately \$5 million for the period from January to April of 2010. FTB notes that the total amount reflected in the revenue checks provided was less than the gross receipts evidenced by deposits into appellant's bank accounts. FTB observes that it allowed appellant a greater amount of subcontractor expenses than appellant claimed as COGS and determining expenses was difficult because appellant paid expenses in cash and did not have checks or similar evidence showing its payments.

FTB's Reduction of its Proposed Assessment During Appeal

18. In its final brief, FTB reduced its proposed assessment by \$78,717. The reduced proposed assessment reflected FTB's allowance of \$1,050,703 of subcontractor expenses that it had previously disallowed as loan payments. The amount of the resulting reduction was subsequently reduced because FTB also increased appellant's gross income by \$52,342 due to adjustments to its bank deposit analysis.

Other Audits of Appellant

19. The IRS examined appellant's 2010 tax return and made no adjustments. It is not clear what records, if any, the IRS examined for appellant's 2010 tax year.

DISCUSSION

Burden of Proof

FTB's determination is presumed to be correct, and a taxpayer has the burden of proving error. (*Appeal of Wright Capital Holdings, LLC*, 2019-OTA-219P.) A taxpayer cannot carry that burden without providing "credible, competent, and relevant evidence as to the issues in dispute." (*Ibid.*)

COGS

By its own description, appellant is engaged in a service business. There is no evidence that it carried goods or inventory. Accordingly, FTB correctly determined that appellant could not have COGS. (See Treas. Regs. §§ 1.61-3(a); 1.162-1(a); *Womack v. Commissioner*, T.C. Memo. 1996-242.)¹⁰

Subcontractor Expenses

Appellant seeks an increased deduction for subcontractor expenses it allegedly paid in 2010. FTB examined appellant's books and records to determine the amount of appellant's subcontractor expenses, and although the available records did not include canceled checks or electronic transfers, FTB has allowed appellant \$12,752,556 of subcontractor expense based on the Initial Invoices.¹¹

Income tax deductions are a matter of legislative grace, and taxpayers who claim a deduction has the burden of proving by competent evidence entitlement to that deduction. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79; *Appeal of Vardell*, 2020-OTA-190P.) Taxpayers must maintain records relating to their income and expenses and must prove their entitlement to all claimed deductions and expenses in controversy. (*Canatella v. Commissioner*, T.C. Memo. 2017-124; *Cherizol v. Commissioner*, T.C. Memo. 2014-119.) An expense may be deductible even where the taxpayer is unable to fully substantiate it. (*Christine v. Commissioner*, T.C. Memo. 2010-144.) However, there must be sufficient evidence in the record to provide a basis upon which an estimate may be made, and to conclude that a deductible expense was incurred in at least the amount allowed. (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, 543-544; *Vanicek v. Commissioner* (1985) 85 T.C. 731.)

When there is sufficient evidence indicating a taxpayer incurred a deductible expense or loss, but the precise amount cannot be determined, a fact finder may approximate the amount of the deduction, *bearing heavily against a taxpayer* whose inexactitude is of his or her own making. (See *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d. 540, 543-544, italics added.)

¹⁰ As relevant here, California conforms to IRC sections 61 and 162, and regulations thereunder. (R&TC, §§ 17071, 17201, 17024.5(d), 23051.5(d).)

¹¹ This amount consists of the \$11,809,746 of expense reflected in FTB's NOA, plus the \$1,050,703 of additional expense allowed and minus the \$107,893 disallowed on appeal. Appellant's reported COGS included only \$3,111,361 paid to subcontractors.

Determining whether a taxpayer has satisfied his or her burden of substantiating a deduction does not require acceptance of the taxpayer's self-serving, undocumented testimony. (*Niedringhaus v. Commissioner* (1992) 99 T.C. 202, 219–220.)

Appellant has not provided any reliable evidence showing it incurred more than \$12,752,556 of subcontractor expenses. Appellant's Later Invoices were created during the audit and appellant has not established or explained why they are credible. Among many other deficiencies detailed above, the Later Invoices report purported billings from and to subcontractors in the same amount and on the same day.

During appeal, appellant asserted that it has 25 boxes of additional documentation that are "exactly like" the Initial Invoices. However, when OTA provided a further opportunity for appellant to provide documentation from these boxes, the invoices appellant provided were very different from the Initial Invoices which FTB reviewed. Like the Later Invoices, the invoices appellant provided were created during the audit and do not credibly substantiate any subcontractor expense, for the reasons set forth above. For example, they do not include reliable corroborating documents such as credible invoices, agreements, or other documents showing the nature of the services provided, or to whom and in what amount expenses were in fact paid.

OTA asked the parties to provide additional briefing regarding whether additional expenses might be reasonably estimated. After reviewing the additional evidence and argument provided by the parties, OTA finds that FTB has already allowed substantial expense deductions that are not directly evidenced by cancelled checks, electronic transfers or reliable accounting records, and we do not see a reliable basis to allow further expense deductions. We are reluctant "to disturb [FTB's] determinations involving unsubstantiated amounts without independent facts on which to base a different finding." (*Appeal of California Steel Industries, Inc.* (2003-SBE-001-A) 2003 WL 21693873.)

Appellant argues that OTA can extrapolate from the auditor's review of revenue checks for January through April 2010 that it had total expenses of \$7,894,895. However, notwithstanding appellant's claimed total expense amount is *less* than the amount of subcontractor expense that FTB allowed, appellant's argument that it is entitled to deduct

95 percent of its gross receipts as subcontractor expenses is not supported by the record.¹² FTB compared appellant's Initial Invoices and bank statements from January to April 2010¹³ to the client revenue checks disbursed in the same time period, which showed that the amounts paid to its clients/subcontractors were 83 percent of appellant's gross receipts, not 95 percent as appellant claims. Appellant provided insufficient additional evidence that reliably supported its claim that subcontractor expenses equaled 95 percent of gross receipts, and thus, appellant's argument is unavailing. Appellant provided the Later Invoices and additional invoices on appeal to show appellant paid additional amounts as subcontractor expenses; however, these documents are deemed unreliable for the reasons set forth above. Thus, appellant has not met its burden to show it incurred additional subcontractor expenses to warrant an increased deduction.

Appellant argued at the hearing that OTA should allow COGS or additional business expense deductions based on amounts allowed in other audits. However, appellant pointed to FTB examinations of other tax years, and it is well established that each tax year stands on its own. (See, e.g., *Appeal of Laude* (76-SBE-096) 1976 WL 4112.) Appellant also pointed to the IRS's audit of appellant's 2010 tax year; however, the record does not show the scope of the IRS's examination, the records it considered, or the basis for its determination. In any event, neither FTB nor OTA is bound to adopt the conclusion of the IRS even if it results from a detailed audit. (See, e.g., *Appeal of Bertrand* (85-SBE-071) 1985 WL 15852.)

¹² For example, appellant describes the amount of \$10,013,550 as other income for the May to December 2010 period. However, the \$10,013,550 amount is not an income amount for the May to December 2010 period; it is FTB's total proposed net income adjustment for the entire 2010 tax year (after accounting for allowed deductions and the elimination of COGS, before FTB's later concession allowing \$1,050,703 of additional subcontractor expense).


¹³ Appellant's Initial Invoices covered dates throughout 2010; however, FTB only analyzed a subset of appellant's Initial Invoices – those from January to April.

HOLDING


Appellant has not shown it is entitled to a deduction for additional COGS or subcontractor expense deductions in excess of those allowed by FTB.


DISPOSITION

As modified on appeal by its reduction of proposed tax, FTB’s action is sustained.

DocuSigned by:

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Richard Tay
Administrative Law Judge

We concur:

DocuSigned by:

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Ovsep Akopchikyan
Administrative Law Judge

DocuSigned by:

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Asaf Kletter
Administrative Law Judge

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