

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 15440
[Redacted],)	
)	DECISION
Petitioners.)	
_____)	

On December 18, 2000, the Income Tax Audit Division of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to [Redacted] (taxpayers), asserting additional income tax, penalty and interest in the amount of \$11,539 for the 1996 through 1999 taxable years. On February 16, 2001, the taxpayers filed a timely appeal and petition for redetermination. An informal conference was held in Boise, Idaho, on April 29, 2001. The taxpayers provided additional information shortly after that informal conference. The Tax Commission, having reviewed the file, hereby issues its decision.

[Redacted] is a licensed veterinarian who operates a successful veterinary and embryo transfer clinic from the taxpayers' small farm near [Redacted], Idaho. The clinic is operated as a sole proprietorship. Mrs. [Redacted] is also actively involved in the business performing various secretarial, janitorial, bookkeeping, and other services. The Tax Commission's income tax audit staff conducted an audit of the business for the 1996 through 1999 taxable years. As a result of this audit, a number of deductions claimed on the Schedule C were disallowed under Internal Revenue Code § 262 as personal, living or family expenses. In their protest, the taxpayers contend that the auditor incorrectly disallowed expenses related to: (1) an employer provided medical reimbursement plan; (2) legal fees incurred in fighting a proposed hazardous waste treatment facility; and (3) feed costs. The Tax Commission will address each of these challenged audit adjustments in turn.

1. Disallowed Employer Provided Medical Reimbursement Plan Expenses.

In 1995 [Redacted] set up a medical reimbursement plan for his employees under the provisions of Internal Revenue Code § 105(b). Under such a plan, amounts paid by the business to a covered employee to reimburse the employee for expenses incurred for medical care of the employee, his spouse or his dependents is not treated as income of the employee. I.R.C. § 105(b). In addition, under Internal Revenue Code § 162 and Treasury Regulation 1.162-10(a), the amount paid by the employer under the terms of the plan is treated as an ordinary and necessary business expense. A self-employed individual is not considered an “employee” for purposes of a qualifying employer-provided medical reimbursement plan. I.R.C. § 105(g).

One of the covered employees under the medical reimbursement plan set up by [Redacted] was his wife, [Redacted]. According to [Redacted], [Redacted] works full time at the clinic answering the phones, scheduling appointments, performing other secretarial and bookkeeping duties, and helping out in the clinic as a veterinary technician as needed. No records were maintained by the business of the actual hours or days Mrs. [Redacted] worked. In addition, there was no employment agreement entered into; Mrs. [Redacted] salary was paid annually rather than bi-weekly or monthly; and the amount of her compensation appears to be entirely unrelated to the actual amount of time she worked during the year. Mrs. [Redacted] earned \$5,000 for her services in 1996, \$2,000 in 1997, and \$2,165.67 in 1998.

Pursuant to IRS guidelines, in order for medical reimbursement expenses to be deductible by a sole proprietor who is paying medical benefits to his spouse, the spouse must be a *bone fide* employee of the business. Rev. Rul. 71-588, 1971-2 C.B. 91. The purpose of this rule is to prevent a sole proprietor from deducting otherwise non-deductible personal health care expenses under the guise of providing medical reimbursement coverage to an “employee.”

After reviewing the record, the Tax Commission finds that Mrs. [Redacted] was not a *bone fide* employee of the business during 1996 through 1998. That is not to say that Mrs.

[Redacted] did not perform services for the business; but her services were more akin to that of a proprietor, partner or stakeholder in the business and not as an employee. Factors that establish that Mrs. [Redacted] was not a *bone fide* employee of the business include:

- No employment agreement.
- No time records showing the hours or days Mrs. [Redacted] worked.
- The fact that Mrs. [Redacted] was not paid on a bi-weekly or monthly basis as is the norm for an employee.
- The fact that the annual salary received by Mrs. [Redacted] was not reasonable in light of the amount of work she purportedly performed during the year. Assuming that Mrs. [Redacted] worked only 20 hours per week for 50 weeks per year, her salary in 1996 would barely exceed the Idaho and federal minimum wage. Her salary in 1997 and 1998 would be well under the state and federal minimum wage laws.
- The fact that in the three years under review (1996 through 1998) Mrs. [Redacted] was the only person who made a claim for reimbursement under the plan. It is not entirely clear whether any other employees of the business were covered, but 100% of the reimbursements paid out under the plan were based on claims submitted by Mrs. [Redacted].

Taken as a whole, the Tax Commission finds that Mrs. [Redacted] was not a *bona fide* employee of the veterinary and embryo transfer clinic as required under Internal Revenue Code § 105(b) and Revenue Ruling 71-588. As a result, the taxpayers are not entitled to any of the disallowed medical reimbursement plan expenses.

2. Disallowed Legal Fees.

The taxpayers deducted \$5,078.21 for legal fees paid in 1998 relating to an attempt to persuade the [Redacted] County and [Redacted] County planning and zoning committees to reject a proposed hazardous waste treatment facility that was set to be built on a farm adjacent to the [Redacted] property. It was feared that the waste treatment plant would adversely affect the embryo transfer operations being conducted at the [Redacted] farm. The auditor disallowed the expenses under Internal Revenue Code § 262 because the taxpayers had not established that the legal fees were ordinary and necessary business expenses. However, the information provided by the taxpayers during the informal conference clearly evidences that the proposed facility posed a genuine threat to the embryo transfer clinic. Therefore, the Tax Commission finds that there was a legitimate business purpose for the legal fees. As a result, the entire \$5,078.21 expenditure will be allowed as an ordinary and necessary business expense.

3. Feed Purchases.

The final audit adjustment challenged by the taxpayers relates to hay and feed purchases they made in 1997 and 1998. As part of the veterinary and embryo transfer business, Dr. [Redacted] often houses animals overnight or for a period of days at his farm. Therefore, in addition to their own animals, the taxpayers also house and feed animals belonging to clients. In 1997 and 1998 the taxpayers purchased \$3,827 of hay and feed. Unfortunately, during the years under review, the taxpayers did not maintain any records to establish how much hay and feed was used with respect to their business or how much was used with respect to their personal animals.

During the informal conference the taxpayers asserted that between 85 percent and 90 percent of their hay and feed purchases were used to bed and feed animals being treated at the veterinary and embryo transfer clinic. Presumably the remainder of the hay and feed was used for the taxpayers' own animals. In any event, the auditor disallowed all of the hay and feed

purchases because the taxpayers were unable to verify how much, if any, was used in the business.

The taxpayers admit that they did not keep detailed records identifying the amount of hay and feed used in the business, but suggest that the Commission should allow a reasonable estimate rather than simply disallowing all of these expenses. The taxpayers also indicated that they have taken steps to correct the record keeping problems that resulted in the inability to verify the amount of hay and feed purchases used in the business.

It is a well-recognized tenant of income tax law that a taxpayer bears the burden of establishing that he is entitled to a deduction. Potlatch Corp. v. Idaho State Tax Com'n, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440, 54 S.Ct. 788, 790 (1934). If a taxpayer is unable to provide adequate proof of any material fact upon which a deduction depends, no deduction is allowed and that taxpayer must bear his misfortune. Burnet v. Houston, 283 U.S. 223, 51 S.Ct. 413 (1931). However, in many cases where a taxpayer fails to keep detailed books and records, adequate proof of the deductibility of an expense can be established by other competent evidence. Furthermore, if the taxing authority is satisfied that some business expense was actually incurred but the exact amount of the deductible expense is unknown, it may make an estimate of the deductible amount of the expense. Cohan v. Commissioner, 39 F.2d 540, 543-544 (2nd Cir. 1930). But see I.R.C. § 274 (Estimation is not allowed for certain travel and entertainment expenses, business gifts, or expenses related to “listed property.”). Quite naturally, the estimate of the amount of the deductible expense is within the sound discretion of the taxing authority and the courts will usually sustain the estimate in the absence of proof in support of a greater deduction.

In the present case the Tax Commission is satisfied that some amount of the hay and feed purchased by the taxpayers during 1997 and 1998 was used in the veterinary and embryo transfer

business. Therefore, an estimate of the deductible amount of the hay and feed expenditures is warranted. Absent adequate books and records to verify how much of the hay and feed was used in the business operations, the Tax Commission is not prepared to allow a deduction of 85 percent to 90 percent as suggested by the taxpayers. The Commission finds that 50 percent is a more reasonable estimate. Therefore, the Notice of Deficiency Determination will be modified to allow as an ordinary and necessary business expense 50 percent of the hay and feed purchases listed in the taxpayers' general ledger for 1997 and 1998.

WHEREFORE, the Notice of Deficiency Determination dated December 18, 2000, is hereby MODIFIED and, as so modified, is APPROVED, AFFIRMED, AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1996	\$2,521	\$126	\$ 885	\$ 3,532
1997	3,941	197	1,039	5,177
1998	1,893	95	352	2,340
1999	199	0	22	<u>221</u>
		TOTAL DUE		<u>\$11,270</u>

Interest is calculated through September 15, 2001, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6)(b) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayers' right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2001.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2001, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

DR. [Redacted] Receipt No. [Redacted]
[Redacted] [Redacted]
[Redacted]

ADMINISTRATIVE ASSISTANT 1