

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

| | | |
|---------------------------------|---|------------------|
| In the Matter of the Protest of |) | |
| |) | DOCKET NO. 16946 |
| [Redacted], |) | |
| |) | DECISION |
| Petitioner. |) | |
| _____ |) | |

On August 9, 2002, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayer) asserting additional Idaho income taxes and interest in the amount of \$3,528 for the 1998 through 2000 taxable years. A timely appeal and petition for redetermination was filed by the taxpayer. The taxpayer did not request an informal hearing before the Commission, but she did provide a box of receipts and sundry records for the Commissioners to consider in deciding this protest. The Commission, having reviewed the file, hereby issues its decision upholding the Notice of Deficiency Determination.

The issue in this administrative protest relates to the disallowance of business expenses claimed by [Redacted] on her 1998 through 2000 income tax returns. During those years [Redacted] owned and operated a computer services business. The income and expenses of that business were reported on federal Schedule C, which is the schedule used to report profit and loss from a sole proprietorship. During the years at issue [Redacted] reported net losses from her computer service business of \$9,975 in 1998, \$12,647 in 1999, and \$14,603 in 2000.

The Income Tax Audit Division of the Idaho State Tax Commission selected [Redacted] 1998 through 2000 Idaho income tax returns for audit. As part of that audit [Redacted] was asked to produce receipts, cancelled checks, and vehicle mileage logbooks necessary to substantiate the various expenses claimed on the federal Schedule C forms attached to her federal

individual income tax returns. In response, [Redacted] provided the auditor with a banker's box full of receipts, cancelled checks, pay-stubs, and other documents of various types. Apparently [Redacted] felt that buried within that box of records were the specific records that the auditor had requested.

After reviewing the box of records, the Tax Commission's auditor returned the box to [Redacted] with instructions to "provide only the documentation pertaining to your Schedule C's for the referenced tax years." See letter dated May 7, 2002, from [Redacted] to [Redacted]. In an e-mail sent May 19, 2002, [Redacted] indicated that she would retrieve the box of records from the auditor and would "have it for you by June 15th." See e-mail dated May 19, 2002, from [Redacted] to [Redacted]. Although not entirely clear, based on her e-mail message it appeared that [Redacted] understood that she was being asked to cull through the box of records and to provide the auditor with only those records relating to the questioned Schedule C business expenses. However, in her subsequent letter of protest (discussed in greater detail below), [Redacted] indicates that she does not understand what it is she is being asked to do with respect to the records she provided to the auditor. In any event, [Redacted] did not meet the June 15, 2002, deadline set out in her e-mail message, and the Notice of Deficiency Determination that is the subject matter of this protest was then issued. In the Notice of Deficiency Determination all of the business expenses claimed by [Redacted] on her 1998 through 2000 returns were disallowed.

In her October 8, 2002 letter of protest, [Redacted] states that she is:

still unclear as to what you need. Everything is in the box. All of my checking account statements, etc. My checks are noted on them if they are a business expense. I list 'comp.' or 'comp. bus.' on them. It is hard to miss. If you would like me to do your auditing for you, then please instruct me as to how you want the information.

See letter dated October 8, 2002, from [Redacted] to the Idaho State Tax Commission. Thus, from her letter of protest, it appears that [Redacted] did not understand that the auditor had returned that box of records to her for the purpose of having her cull through the thousands of receipts and documents contained therein and then to resubmit only those that pertained to the business expenses claimed on the federal Schedule C forms. This misunderstanding or miscommunication is unfortunate. Had [Redacted] correctly understood the auditor's request and made an effort to provide only the specific records relating to the questioned business expenses, many of those expenses may have been allowed. But, in the final analysis, the records required by the Tax Commission's audit staff were not submitted in the form requested, and all of the claimed business records have now been disallowed for inadequate substantiation.

Other than this box of receipts and other sundry records, it does not appear that the taxpayer maintains any traditional accounting records relating to her computer service business. From the information available to the Commission it appears that she did not maintain a separate business checking account for her computer service business; and she maintained no cash receipt and disbursement journal, no general journal, or any other accounting journals or ledgers designed to capture and categorize the various business expenditures incurred during the years at issue. Instead, she simply retained various receipts, cancelled checks, and other documents, most of which appear to be entirely unrelated to her Schedule C business. For example, in the packet of documents labeled "April 1998" that was included within the box of records provided by [Redacted], there were 61 pieces of paper that can be broken out into the following categories:

| <u>Description</u> | <u>Number</u> |
|--|---------------|
| • Cash register receipts showing purchases | 35 |
| • Bank account deposit receipts and/or balance summaries | 12 |
| • Bills, statements, invoices, or guest receipt stub | 5 |

- Pay stubs 1
- Receipts showing payments received for services 1
- Refund on return of merchandise receipts 1
- Post-it notes with handwritten notations 5
- Secretary's Day card 1

In another example, the packet of records labeled December 1999 contained 107 pieces of paper, which can be broken out as follows:

| <u>Description</u> | <u>Number</u> |
|--|---------------|
| • Cash register receipts showing purchases | 44 |
| • Bank statements and cancelled checks | 47 |
| • Bills, statements, or invoices | 11 |
| • Pay stubs | 4 |
| • Bank account deposit receipts | 1 |

All totaled, there are 49 packets of records contained in the box provided by [Redacted], and each packet appears to contain on average around 80 to 100 documents. Thus, by this rough estimate, there are somewhere in the neighborhood of 4,000 to 5,000 cash register receipts, cancelled checks, bills and invoices, pay stubs, and other sundry documents contained in the box provided by [Redacted]. More importantly, the vast majority of these documents and records appear to have nothing whatsoever to do with her computer services business or with the specific business expenses she listed on her federal Schedule C forms.

Generally speaking, ordinary and necessary expenses actually incurred in connection with a trade or business are deductible under Internal Revenue Code § 162. Personal expenses are not deductible. I.R.C. § 262. Likewise, capital expenditures are not deductible except to the extent allowed by Internal Revenue Code §§ 263, 167, or 179. An expense is “ordinary” if it is customary or usual within the experience of a particular trade, business, or industry. Welch v.

Helvering, 290 U.S. 111, 54 S.Ct. 8 (1933). An expense is “necessary” if it is reasonable in amount and helpful with respect to developing and maintaining the taxpayer’s trade or business. Id. When the Internal Revenue Service or a state taxing authority challenges a claimed business expense, the burden of proof is on the taxpayer to show that he is entitled to the deduction. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440, 54 S.Ct. 788, 790 (1934). In most circumstances, the taxpayer is required to establish by a preponderance of the evidence that the expense was actually paid or incurred during the taxable year, the amount of the expense, and that it was an ordinary and necessary expense of the taxpayer’s trade or business. This proof is generally met through the taxpayer’s books and records. However, where the taxpayer’s books and records are inadequate to substantiate the deductibility of the expenditure, other credible evidence may be accepted and, in certain cases, reasonable estimates may be used. Cohan v. Commissioner, 39 F2d 540 (2nd Cir. 1930). Additional record keeping and substantiation requirements apply to expenses relating to (1) travel and entertainment, (2) gifts, and (3) automobiles and other “listed property.” See I.R.C. § 274(d); Treas. Reg. § 1.274-5T.

In the present case, the taxpayer has been unable to directly substantiate any of the expenses she claimed on the Schedule C forms attached to her 1998 through 2000 income tax returns. Instead, she has simply resubmitted the box full of receipts and sundry records that she provided at the audit. The Commission has taken a cursory review of that box of records. Unfortunately for [Redacted], the Commission is not inclined to spend its time and resources culling through those records to try to determine which ones might have some bearing on this audit. [Redacted] needs to take responsibility for maintaining proper books and records relating to her Schedule C business. To the extent that she has not maintained adequate business records,

she has the responsibility of presenting what documents and materials she does have in a logical and coherent manner.

It is well established in Idaho that a Notice of Deficiency Determination issued by the State Tax Commission is presumed to be correct and the burden is on the taxpayer to establish that the amount being assessed is erroneous. Albertson's, Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984) (The burden of proof is on the taxpayer to prove that the decision of the Tax Commission is incorrect.); Parsons v. Idaho State Tax Commission, 110 Idaho 572, 574-575 n.2, 716 P.2d 1344, 1346-1347 n.2 (Ct. App. 1986) (a State Tax Commission deficiency notice is presumed to be correct and the burden is on the taxpayer to show that the deficiency is erroneous). In addition, under both Idaho and federal income tax law, it is the taxpayer who bears the burden of establishing that he or she 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. Thus, 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 and Treasury Regulation § 1.274-5T. (Estimation is not allowed for certain travel and entertainment expenses, business gifts, or expenses related to “listed

property.”) The manner in which the deductions are estimated, and the amount of estimated deductions to be allowed, are within the sound discretion of the taxing agency.

When contesting the disallowance of a deduction, the taxpayer is normally required to present his evidence relating to a disallowed deduction in a manner that is logical and readily understandable. Otherwise, the taxpayer runs the risk that the taxing agency or the court might misunderstand the evidence presented or might simply decline to wade through the hodgepodge of records and documents submitted by the taxpayer in an effort to try to figure out what relevant evidence might be buried in the morass of papers. *See, e.g. Kersting v. C.I.R.*, T.C. Memo 1999-197 (U.S. Tax Court 1999) (“Petitioner invites the Court implicitly to wade through the numerous checks in the record, calculator in hand, to come up with the purported amounts of alleged business expenses. We decline this invitation.”). This principle was artfully set forth some seventy years ago in *Evergreen Cemetery Ass’n v. Comm’r*, 21 B.T.A. 1194 (1932):

The proper trial of a case before the Board requires thorough preparation, a clear understanding of the issues, and the marshaling of the evidence in such a way to indicate clearly the effect of the same and the issue to which it appertains. This is not accomplished by dumping into the hands of the Board a number of books of account and other similar evidence. Such evidence is not self-illuminating. The Board should not be asked to ferret out the correct answer to technical or difficult questions of law and fact from unexplained, uncoordinated evidence.

Id.

The box of receipts and other records provided by [Redacted] in support of her petition for redetermination is, likewise, “not self-illuminating.” The Tax Commission declines [Redacted] invitation to wade through the thousands of pieces of paper she has provided in an effort to “ferret out” those receipts that could possibly relate to her Schedule C computer service business. Providing the Tax Commission with a box full of records, the vast majority of which clearly relate to personal expenditures, is not sufficient to meet her burden of proof in this matter.

If [Redacted] is unwilling to take it upon herself to provide the Commission with only those records and documents that are related to her Schedule C business expenses, the Commission has no alternative but to uphold the audit determination.

WHEREFORE, the Notice of Deficiency Determination dated August 9, 2002, is hereby APPROVED, AFFIRMED and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following taxes and interest:

| <u>YEAR</u> | <u>TAX</u> | <u>INTEREST</u> | <u>TOTAL</u> |
|------------------|------------|-----------------|----------------|
| 1998 | \$784 | \$230 | \$1,014 |
| 1999 | 967 | 212 | 1,179 |
| 2000 | 1,240 | 173 | 1,413 |
| TOTAL AMOUNT DUE | | | <u>\$3,606</u> |

Interest is calculated through March 31, 2003, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

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

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

DATED this _____ day of _____, 2003.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2003, 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:

[Redacted]
