

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 17375
[REDACTED],)	
)	DECISION
Petitioners.)	
_____)	

On April 12, 2002 and April 7, 2003, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission issued Notices of Deficiency Determination to [Redacted] (taxpayers), proposing additional income tax, penalty, and interest for the taxable years 1998 and 1999 through 2000, respectively, in the total amount of \$118,172.

On May 10, 2002 and June 4, 2003, the taxpayers filed timely appeals and petitions for redetermination. The taxpayers did not request a hearing but rather wanted to continue discussions of the issues that were unresolved at the audit level. The Tax Commission, having reviewed all the information presented and made available, hereby issues its decision.

The Income Tax Audit Bureau (Bureau) selected the taxpayers' 1998 through 2000 Idaho income tax returns for examination. The 1998 return was approaching the statute of limitations, so the Bureau requested a waiver. The taxpayers did not respond, and the Bureau issued a provisional Notice of Deficiency Determination. The taxpayers protested the determination thus keeping the 1998 return open for further adjustment or modification.

The Bureau continued with its examination of the taxpayers' 1999 and 2000 returns. The Bureau made adjustments to those returns and sent the taxpayers a second Notice of Deficiency Determination. Again, the taxpayers disagreed with the Bureau's determination and protested the Notice of Deficiency Determination.

The taxpayers and the Bureau continued to work together to resolve their differences in the audit. The taxpayers agreed to some changes and the Bureau accepted additional information

and documentation in support of the taxpayers' position. The Bureau modified the original audit reports and sent copies to the taxpayers for their approval. The taxpayers continued to disagree with some key issues and they requested that the matter be moved to the administrative appeal level.

The Tax Commission reviewed the matter and gave the taxpayers the choice of two alternative methods for having the Notices of Deficiency Determination redetermined. The taxpayers, through their representative, chose to continue discussing the remaining issues and to provide any additional information the Tax Commission needed.

The unresolved issues the taxpayers wanted reviewed were: 1) the starting taxable income for adjustment purposes on the taxpayers' 1999 Idaho return; 2) the charitable contributions disallowed and the carryover amounts; 3) the disallowed margin investment interest expense; 4) the disallowed real estate taxes; and 5) the addition of penalties. The other adjustments made in the original audit reports and subsequently left unchanged or modified in the modified audit report were stipulated and agreed to by the taxpayers and the Bureau. Those adjustments are not addressed in this decision except to say that the Tax Commission upholds those adjustments.

Issue 1

The Bureau's calculation of the taxpayers' deficiency for tax year 1999 started with the taxpayers' taxable income that should have been reported on their 1999 Idaho individual income tax return. On the 1999 return, the taxpayers reported zero Idaho taxable income. However, that number did not fully account for the taxpayers' itemized deductions and personal exemptions. If the taxpayers would have completed the math, their Idaho taxable income for 1999 was a negative amount, not zero. The Bureau correctly calculated the taxpayers' Idaho taxable income

and used that number as a starting point. After this was explained to the taxpayers, they agreed with the Bureau's starting point.

Issue 2

The taxpayers claimed charitable contributions on their 1998, 1999, and 2000 returns. Included in the contribution amounts were carryover contributions from taxable years as early as 1995. The Bureau questioned the contributions made in the current years under review as well as the carryover amount from previous years.

In 1998, the taxpayers contributed non-cash items in the amount of \$93,914. However, the taxpayers claimed non-cash contributions in the amount of \$187,828 on their 1998 return. The taxpayers agreed that the correct amount was \$93,914.

In 1999, the taxpayers claimed cash contributions in the amount of \$79,106. The taxpayers documented \$68,356 of cash contributions. The difference of \$10,750 was determined not allowable because it was for tuition to [Redacted]. The taxpayers agreed.

In 2000, the taxpayers claimed cash contributions totaling \$5,748. However, the taxpayers could only document cash contributions totaling \$4,448. The taxpayers did not contest this adjustment.

In addition to the contributions made in the current years under review, the taxpayers reported unused carryover contributions. The Bureau initially disallowed the carryover contributions because the taxpayer did not substantiate the contributions. However, the taxpayers did provide evidence that the Internal Revenue Service (IRS) looked at the taxpayers' contributions in one of the years creating the carryover. The IRS adjusted the taxpayers' contributions for that year to conform the contribution deduction to the percentage limitations.

Internal Revenue Code section 170 sets forth limitations on the amount of charitable contributions that can be deducted in a taxable year. The limitations are 50%, 30%, and 20% depending on the contribution and the donee. The taxpayers contributed non-cash items, which are limited to 30% of the taxpayer's adjusted gross income. However, the taxpayers reported their non-cash contributions using the 50% limitation. Since carryover contributions retain the character of the contribution from which the carryover is derived and the taxpayers continued to claim the carryover contributions at the 50% limitation, an adjustment needed to be made in the carryover years.

The taxpayers provided copies of the corrected contributions and the carryover amount after the federal audit. From that starting point, the Tax Commission calculated the taxpayers' charitable contribution carryover into 1998, 1999, and 2000. The Tax Commission adjusted the taxpayers' contribution carryover in each of the years because of the incorrect contribution limitation percentage and a reduction in the total amount of non-cash contributions coming out of the federal audit.

Issue 3

The taxpayers claimed investment interest expense in each of the years. The taxpayers claimed the expense was interest on a margin account. The Bureau asked the taxpayers to document the interest, and they provided the Bureau with copies of their margin account statements. The Bureau viewed the interest as coming from loans on the taxpayers' margin account. The taxpayers did not substantiate what the loan proceeds were used for, so the Bureau disallowed the expense as being related to personal expenditures.

The taxpayers disagreed with the Bureau's determination. They stated the margin interest was not for loans or funds taken out of the margin account. The taxpayers stated the charges to

the account were more like management fees that are expenses of their investments. Expenses that are deductible.

The broker statements the taxpayers provided to substantiate the investment expense clearly show that the account was charged interest. The taxpayers' account maintained a very large credit balance. The interest charge against the account was recorded as a debit balance on the account. The statements provided showed the debit balance increasing on a monthly basis.

Revenue Ruling 70-221 specifically addressed interest charged on a margin account. It states that for cash-basis taxpayers, interest charged by a broker on indebtedness under a margin account is actually or constructively paid for federal income tax purposes only as the broker receives payments from the taxpayer. In this case, the taxpayers' margin account is charged for interest and/or for management fees. The charges to the account appear as a debit against the taxpayers' credit balance. According to the broker, debit balances appearing on their clients' statements are just bookkeeping entries showing the interest charged on the account. The broker collects the debit balance at a later date when the securities are sold or if dividends are paid. The taxpayers could also pay the charges by paying the broker directly.

The taxpayers have not shown that they paid the interest charges on the margin account. The increasing debit balance is evidence that no payments have been made. Therefore, the Tax Commission upholds the investment interest expense adjustment, not because there were loans that may have been used personally, but because the taxpayers are cash-basis taxpayers and they have not shown the interest was actually or constructively paid as provided in Revenue Ruling 70-221.

Issue 4

The Bureau reviewed and adjusted the amount of real estate taxes the taxpayers claimed. The taxpayers provided amended returns showing a corrected claim for real estate taxes, but the amounts did not agree with what the Bureau verified. The Tax Commission reviewed the documentation the taxpayers provided and found neither the Bureau's nor the taxpayers' amounts accurate.

For 1998, the Tax Commission found that the taxpayers were claiming an amount on a closing statement that was not an expense or cost to them. The taxpayers also claimed the same real estate taxes on their rental schedule that they claimed as an itemized deduction. For 1999, the Tax Commission found that the taxpayers paid more in real estate taxes than what the taxpayers corrected on their amended return. For 2000, the Tax Commission agreed with the amount claimed on the taxpayers' amended 2000 return. After discussing the Tax Commission's findings, the taxpayers agreed with the adjustments.

Issue 5

The Bureau added penalties to the taxpayers' income tax liability. The penalties were added for negligence (Idaho Code section 63-3046(a)) and for substantial understatement of tax (Idaho Code section 63-3046(d)). The taxpayers asked for reconsideration of the added penalties.

Idaho Code section 63-3046(a) states,

If any part of any deficiency is due to negligence or disregard of rules but without intent to defraud, five percent (5%) of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency.

The Bureau added the negligence penalty because the taxpayers made unsubstantiated claims of deductions. The Tax Commission reviewed the case considering the unsubstantiated claims and found that there were in fact claims the taxpayers made that were not substantiated. The Tax Commission also found claims the taxpayers made that disregarded the income tax laws and rules or were the result of carelessness. Therefore, the Tax Commission finds the addition of the negligence penalty appropriate.

Idaho Code section 63-3046(d) states,

- (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent (10%) of the amount of any underpayment attributable to such understatement.
- (2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
 - (i) Ten percent (10%) of the tax required to be shown on the return for the taxable year, or
 - (ii) Five thousand dollars (\$5,000).
- (3) In the case of a corporation, paragraph (d)(2)(ii) of this section shall be applied by substituting ten thousand dollars (\$10,000) for five thousand dollars (\$5,000).
- (4) For purposes of paragraph (d)(2) of this section, the term "understatement" means the excess of:
 - (i) The amount of tax required to be shown on the return for the taxable year, over
 - (ii) The amount of the tax imposed which is shown on the return.
- (5) The amount of the understatement under paragraph (4) shall be reduced by that portion of the understatement which is attributable to:
 - (i) The tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
 - (ii) Any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.
- (6) In the case of any item attributable to a tax shelter as defined in section 6661 of the Internal Revenue Code:
 - (i) Paragraph (5)(ii) shall not apply, and
 - (ii) Paragraph (5)(i) shall not apply unless (in addition to meeting the requirements of such paragraph) the taxpayer

reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(7) The state tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

The taxpayers' deficiency in tax for each of the years is greater than 10% of the tax required to be shown and greater than \$5,000. Therefore, the taxpayers' deficiency falls within the definition of substantial understatement. The adjustments made to the taxpayers' returns were mostly for deductions not substantiated, deductions the taxpayers were not qualified to take, and incorrect applications of the law. Considering this, the Tax Commission does not find that there was reasonable cause for the understatement of tax. Therefore, the Tax Commission upholds the addition of the substantial understatement penalty.

WHEREFORE, the Notices of Deficiency Determination dated April 12, 2002 and April 7, 2003, are hereby MODIFIED, in accordance with the provisions of this decision and, as so modified, are 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>
1998	\$ 5,368	\$ 805	\$ 2,193	\$ 8,366
1999	9,641	1,446	3,232	14,319
2000	5,021	753	1,283	<u>7,057</u>
			TOTAL DUE	<u>\$29,742</u>

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

DATED this ____ day of _____, 2005.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2005, 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]
[Redacted]
[Redacted]

Receipt No.

[Redacted]
[Redacted]
[Redacted]

[Redacted]
[Redacted]
[Redacted]
