

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of )  
 ) DOCKET NO. 18565  
[REDACTED], )  
 ) DECISION  
Petitioners. )  
\_\_\_\_\_ )

On December 1, 2004, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission issued two Notices of Deficiency Determination to [Redacted] (taxpayers). One proposed additional income tax, penalty, and interest for the taxable years 1999 and 2001 in the amount of \$10,004, and one for taxable year 2002 in the amount of \$42,154, for a total amount of \$52,158.

On February 1, 2005, the taxpayers filed a timely appeal and petition for redetermination. The taxpayers did not request a hearing but rather chose to provide additional information for the Tax Commission to consider. The Tax Commission, having reviewed the file and the information presented, hereby issues its decision.

The Income Tax Audit Bureau (Bureau) selected for review the taxpayers' Idaho individual income tax returns for the calendar years 1999 and 2001. The taxpayers filed a 1999 amended return to carry back a net operating loss from 2001. The net operating loss was the result of the flow-through activities of Mrs. [Redacted]'s wholly owned S-corporation. (S-corporation income or loss flows through to the shareholders and is reported on the shareholders' individual income tax returns.)

The Bureau examined the S-corporation's 2001 return and made certain adjustments to the expenses claimed. Those adjustments eliminated the S-corporation's loss reported for 2001. As a result of the adjustments made at the S-corporation level, the Bureau made the corresponding change to the taxpayers' 2001 individual income tax return which eliminated the net operating loss carried back to

their 1999 Idaho income tax return.

The Bureau's examination of the S-corporation included the tax year 2002. However, the taxpayers failed to file their 2002 individual income tax return. Therefore, the Bureau prepared a 2002 return for the taxpayers reporting the income flowing through from the S-corporation.

The Bureau sent the taxpayers a Notice of Deficiency Determination which the taxpayers protested. The taxpayers stated that they disagreed with the adjustments made on the S-corporation's return and that they would provide a 2002 individual income tax return that correctly reported their taxable income.

The Tax Commission addressed the Bureau's flow-through income adjustments in its decision on the S-corporation, [Redacted], Docket Number 18564. In that decision the Tax Commission upheld the adjustments made to the S-corporation's 2001 return and modified the determination made on the S-corporation's 2002 return. Therefore, based upon the nature and character of S corporations, the Tax Commission finds the adjustments to the taxpayers' 1999 and 2001 returns appropriate.

The taxpayers did provide their individual income tax return for 2002. The Tax Commission reviewed that return and found it to be a better representation of the taxpayers' taxable income than the return prepared by the Bureau. Therefore, the Tax Commission accepts the taxpayers' 2002 return in lieu of the return prepared by the Bureau, subject to the normal examination process of the Tax Commission.

The Bureau added interest and penalty to the taxpayers' tax liability. The Tax Commission reviewed those additions and found the interest addition appropriate. However, the negligence penalty added to the taxpayers' 1999 tax liability was determined to be inappropriate. The Bureau applied the negligence penalty because the taxpayers failed to maintain records and they filed returns

containing unsubstantiated claims or substantial errors. The Bureau stated that the penalty was for the understatement of income from a flow-through entity. The Tax Commission sees at least two problems with this addition. First, the penalty is assessed on the taxpayers rather than the entity/taxpayer that had the reporting problem. Second, the penalty is applied to a carryback year not the year of the flow-through income. Therefore, the Tax Commission removes the penalty on the 1999 tax year.

WHEREFORE, the Notices of Deficiency Determination dated December 1, 2004, 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>
1999	\$ 8,097	\$ 0	\$ 3,355	\$11,452
2001	0	0	0	0
2002	(70)	0	0	<u>(70)</u>
			TOTAL DUE	<u>\$11,382</u>

Interest is computed through August 15, 2006.

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

DATED this \_\_\_\_ day of \_\_\_\_\_, 2006.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_ day of \_\_\_\_\_, 2006, 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]

Receipt No.

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