

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 21107
[Redacted],)	
)	DECISION
Petitioner.)	
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On April 14, 2008, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayer) proposing additional income tax, penalty, and interest for the fiscal years ending 1/31/05 and 1/31/06 in the total amount of \$17,193.

On April 22, 2008, the taxpayer, by and through its representative, filed a timely appeal and petition for redetermination. The taxpayer requested a telephonic hearing which was held on December 29, 2008. In attendance at the hearing were [Redacted], shareholders; [Redacted], taxpayer representative; [Redacted], Tax Policy Specialist; and [Redacted], Audit Supervisor. The Tax Commission, having reviewed the file, hereby issues its decision.

BACKGROUND

The Income Tax Audit Bureau (Bureau) initially selected the taxpayer's FY2005 and FY2006 corporate income tax returns for examination of the Idaho credit for qualifying new employees. Upon further review of the taxpayer's returns, the Bureau expanded the scope of the audit to include all business expenses.

The taxpayer is an Idaho corporation that was incorporated on [Redacted]. The taxpayer is a [Redacted] retail store with average annual sales in the neighborhood of \$750,000. The taxpayer was and continues to be located in [Redacted], Idaho. The taxpayer does business

under the name [Redacted]. The taxpayer is wholly-owned by [Redacted] and [Redacted], husband and wife.

The Bureau requested the supporting documentation for the expenses claimed on the taxpayer's corporate income tax returns. The Bureau reviewed the documentation and the information provided by the taxpayer. The Bureau made adjustments to the taxpayer's returns to agree with the books and records provided, but mostly for claimed expenses that were not adequately substantiated with the proper documentation. The Bureau also made adjustments for items that were not business related, items that are required to be capitalized, and disallowed the credit for qualifying new employees.

The Bureau sent the taxpayer a Notice of Deficiency Determination, which the taxpayer protested. The taxpayer stated they were concerned the Bureau did not review the documentation it provided because nearly all the adjustments the Bureau made were supported by documentation as requested. The taxpayer and the Bureau continued their discussions and the Bureau modified its report to allow some of the previously disallowed items. The Bureau sent the taxpayer a modified report to consider, but the taxpayer still disagreed with the audit adjustments. Rather than continue the audit with the Bureau, the taxpayer asked that the matter be forwarded for administrative review.

The Tax Commission reviewed the matter and sent the taxpayer a letter that discussed the methods available for redetermining a protested Notice of Deficiency Determination. The taxpayer requested a telephonic hearing. At the beginning of the hearing, the Tax Commission and the taxpayer agreed that the Bureau's modified audit report would be the starting point for the adjustments made to the taxpayer's income tax returns. The taxpayer was concerned that the Bureau did not consider all the documentation provided during the examination. Specifically,

the taxpayer did not feel the Bureau considered documentation for specific repairs, vehicle expenses and depreciation, an ATV purchase and subsequent depreciation, travel expenses, and cell phone expenses. During the hearing, each of the accounts adjusted by the Bureau were discussed. From the discussion, the Tax Commission asked that the taxpayer provide additional information concerning most of the items disallowed. Other items would be reconsidered based upon the information as documented. The taxpayer asked the Tax Commission to provide it with a list of additional information and/or documentation needed for the expenses. The Tax Commission agreed and stated that a list would be provided within a couple of days.

The Tax Commission provided the taxpayer with an extensive list of the types of documentation needed to substantiate the disallowed expenses. The taxpayer provided substantially less than what the Tax Commission requested. The documentation the taxpayer provided related to its vehicle expenses, cell phone usage, and its 4-wheeler. The taxpayer stated its travel expenses were previously documented as to cost, details of the trips, and purpose of the trips. The taxpayer stated the travel was essential to its business and should be allowed. The taxpayer also stated that it has no further documentation for supplies or the other general ledger items. The taxpayer stated that information was lost when it changed computer systems and that information cannot be recovered.

LAW AND ANALYSIS

Internal Revenue Code (IRC) section 162 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Income tax deductions are a matter of legislative grace, and the burden of clearly showing the right to the claimed deduction is on the taxpayer. Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281, 87 L.Ed. 1607 (1943); Deputy et al. v. Du Pont, 308 U.S.

488, 493, 60 S.Ct. 363, 366, 84 L.Ed. 416 (1940); New Colonial Ice, Inc. Co. v. Helvering, 292 U.S. 435, 440, 54 S.Ct. 788, 790, 78 L.Ed. 1348 (1934). The majority of the disallowed expenses claimed by the taxpayer were disallowed because the taxpayer did not provide adequate documentation and, in some cases, provided no documentation.

The taxpayer claimed expenses for the business use of a vehicle. The Bureau requested documentation showing the business use of the vehicle. The taxpayer stated the business use was 100 percent so it did not need to keep track of the vehicle's usage. However, vehicles are listed property, as provided in IRC section 280F, and they are subject to strict substantiation requirements. IRC section 274(d) lists the required elements needed to substantiate expenses claimed for travel, entertainment, gifts, and the business use of listed property. It states a deduction must be supported by:

. . . adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift.

For vehicles, this generally means an account book, diary, log, expense statement, or trip sheet must be prepared and maintained. Treasury Regulation section 1.274-5T(b)(6) provides the specifics for documenting listed property deductions. It states:

(6) *Listed property*. The elements to be proved with respect to any listed property are—
(i) Amount.
(A) Expenditures. The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures, and
(B) Uses. The amount of each business/investment use (as defined in §1.280F-6T(d)(3) and (e)), based on the appropriate measure (i.e., mileage for automobiles and other means of transportation

and time for other listed property, unless the Commissioner approves an alternative method), and the total use of the listed property for the taxable period.

(ii) Time. Date of the expenditure or use with respect to listed property, and

(iii) Business or investment purpose. The business purpose for an expenditure or use with respect to any listed property (see §1.274-5T(c)(6)(i)(B) and (C) for special rules for the aggregation of expenditures and business use and §1.280F-6T(d)(2) for the distinction between qualified business use and business/investment use).

To substantiate its vehicle expenses, the taxpayer did provide a calendar that identified places where the taxpayer used the vehicle in its business. However, no mileage was listed for any of the business usages. The Bureau asked if the taxpayer had record of the business mileage and total mileage for the vehicle. The taxpayer provided another copy of the same calendar with mileage added. The Bureau determined the calendar was not a contemporaneous record of the taxpayer's use of the vehicle and therefore disallowed all vehicle expenses, including depreciation, because the taxpayer did not meet the strict substantiation requirements for the business use of the vehicle.

The Tax Commission recognizes the fact that the taxpayer used a vehicle in its business; however, without a contemporaneously prepared log to establish the business use and purpose that the vehicle was used, no deduction can be allowed. See Hentges, Michael E., TC Memo 1998-244 (1998); Cottrell, Alvin Floyd Sr., TC Summary Opinion 2008-101 (2008); and Richards, Rick, TC Memo 1999-163 (1999). Yet, since the taxpayer provided rounded mileage estimates to frequently visited business locations that are close approximations of the actual mileage, the Tax Commission sees fit to allow the taxpayer the standard mileage rate as a vehicle expense. See Kasey, J. Bryant, 54 TC 1642 (1970), affd (1972, CA9) 29 AFTR 2d 72-773;

Schumaker, Ralph E., TC Memo 1970-281 (1970), affd (1971,CA6) 29 AFTR 2d 72-352; and Seidel, Arthur R., TC memo 1971-238 (1971).

Another listed property deduction disallowed because the taxpayer failed to provide the required documentation or substantiation is the deduction for cell phones. IRC section 280F(d)(4) specifically identifies cellular telephones as listed property. Therefore, the strict requirements enumerated above are required to deduct cell phone expenses. The documentation the taxpayer provided for its cell phone usage was the monthly statements from the cell phone provider showing only the total amount of the bill. The taxpayer stated the non-business usage of the cell phones was very minimal; less than five percent. Yet, no documentation was provided to substantiate the business usage. The taxpayer also claimed a substantially larger cell phone expense in December 2004. When asked to document this expense, the taxpayer provided a copy of a receipt for an international phone rental that was less than half the amount claimed.

As with the vehicle expense, the taxpayer did not provide the required documentation or substantiation to allow the expenses for its cell phone usage. In addition, the December 2004 expense appears to be related to travel outside the United States, and that travel was primarily personal rather than business related (see the discussion of travel expenses below). Therefore, the Tax Commission upholds the adjustment for the cell phone expenses.

In FY2006, the taxpayer purchased and elected to fully depreciate a Polaris ATV under IRC section 179. The taxpayer stated the ATV was 100 percent business and was used to remove snow from its parking lot and sidewalk. This deduction is also a deduction of listed property; “any property of a type generally used for purposes of entertainment, recreation, or amusement,” (IRC section 280F(d)(4)(A)(iii)). The taxpayer provided no information on the

ATV during the Bureau's examination. Later, the taxpayer provided a copy of the 2009 vehicle registration and copies of insurance information on the ATV for May 2008 to May 2009.

As listed property, the taxpayer was required to substantiate the business use of the ATV. The taxpayer claimed 100 percent business use, yet provided no documentation. The ATV is insured under the taxpayer's sole shareholders' homeowner's insurance. In addition to the ATV being covered under homeowner's policy, the shareholders also insured a Polaris snowmobile. This draws serious question that the ATV was used 100 percent for the taxpayer's business. Regardless, the taxpayer did not provide the necessary documentation to substantiate the business use of the ATV. Therefore, the Tax Commission upholds the Bureau's disallowance of the depreciation and expenses related to the ATV.

The taxpayer expensed costs for the repair of the water line inside its building. The Bureau reviewed the amounts expensed and determined the amounts should be capitalized. IRC section 263 states that no deduction shall be allowed for any amount paid for permanent improvement or betterments made to increase the value of any property. The Bureau determined the repairs had a useful life of greater than one year and it added to the value of the building.

Whether an expenditure may be deducted or must be capitalized is a question of fact. INDOPCO, Inc. v. Commissioner, 112 S.Ct. 1039 (1992). In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. Illinois Merchants Trust Co., Executor v. Commissioner, 4 B.T.A. 103 (1926).

An important factor in determining whether the appropriate tax treatment is immediate deduction or capitalization is the taxpayer's realization of benefits beyond the year in which the expenditure is incurred. This is not an absolute rule, however, as the benefits of expenditures considered to be currently deductible as repairs sometimes extend beyond the current year, as would be true, for example, of the cost of replacing a broken windowpane. Tsakopoulos v. Commissioner, 83 T.C. Memo 1064, (2002). Although the mere presence of an incidental future benefit--"some future aspect"--may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. Indeed, the provision of IRC section 263(a)(1), referring to "permanent improvements or betterments," envisions an inquiry into the duration and extent of the benefits realized by the taxpayer. INDOPCO, Inc. v. Commissioner, Id.

The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery. While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset. The IRC endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. INDOPCO, Inc. v. Commissioner, Id.

The repairs in question were to the water line of the building the taxpayer was leasing from its shareholders. The lease agreement is vague in its terms on who is responsible for repairs of this nature. If the repairs are the responsibility of the taxpayer, the taxpayer at the least would be able to amortize the cost over the remaining term of the lease, four years. On the other hand,

if the repairs are the responsibility of the lessor, the taxpayer gets no deduction because the expense is not its expense.

Considering the facts of the matter, the Tax Commission determined the repairs to the water line were expenses of the taxpayer and that they were properly expensed in the year made. However, in reviewing the documentation provided, the Tax Commission found that the concrete work attributed to the water line repairs was far more than the work described by the taxpayer during the hearing. Therefore, the Tax Commission capitalized and amortized the portion of the concrete work added at the job site for work other than repairing the water line.

The taxpayer claimed legal and professional fees in FY2006 for the architectural fees for a remodel of a building the taxpayer was planning to move into. The Bureau disallowed those fees as a current year's expense but allowed a deduction for the amortization of the total cost over the life of the building. The Tax Commission agrees that these costs are properly attributable to the new building and should be capitalized and amortized.

The Bureau examined and disallowed virtually all the expenses the taxpayer claimed as travel and entertainment expenses. The expenses were disallowed on the basis that the taxpayer did not meet the strict substantiation requirements of IRC section 274(d) and that some of the expenses were personal in nature or the primary purpose of the travel was personal. The taxpayer argued that the travel was ordinary and necessary for its retail business. The taxpayer stated that it documented the cost of the travel, provided the details of the trips, and provided the business purpose of the trips. The taxpayer stated the travel should be allowed because it was essential to its business.

As previously stated, IRC section 274(d) enumerates the requirements necessary for travel, entertainment, gifts, and listed property expenses to be allowed as business deductions.

The documentation the taxpayer provided falls far short of the required elements of IRC section 274(d). The taxpayer's documentation consisted of credit card statements and references to web sites. When asked for additional documentation to substantiate the who, when, where, and business purpose, the taxpayer stated it had already been provided, yet the Tax Commission has not seen any of that information.

The taxpayer conceded, during the hearing, that the trips to [Redacted] were primarily personal. As for the other expenses, the travel expenses claimed as fuel and other costs for the vehicle are disallowed per the discussion above; meals are disallowed because no receipts were produced showing who the meal was for, the date, time and place of the meal, the business relationship of the person entertained, or the business purpose of the meal; the other travel expenses for airfare, lodging, and meals are disallowed because no receipts were provided to show who travelled, the number of days or length of the travel, destination of the travel, or the business purpose of the travel. The IRC and the Treasury Regulations are very specific on the requirements for substantiating travel, meals, lodging, and entertainment expenses. Without those elements or sufficient evidence corroborating the taxpayer's statements, no deductions are allowed. Therefore, the Tax Commission upholds the Bureau's adjustment for travel and entertainment.

Lastly, the Bureau adjusted the taxpayer's cost of goods sold, specifically the purchases of inventory. The Bureau adjusted the purchases claimed on the taxpayer's returns to agree with the books and records the taxpayer provided during the audit. The taxpayer disputed the adjustment stating the Bureau did not allow all the purchases made. The Tax Commission reviewed the records and found the Bureau did allow the amount of purchases reported in the taxpayer's books and records. Since the taxpayer provided no further information regarding its

books and records, the Tax Commission upholds the adjustment to the taxpayer's cost of goods sold.

CONCLUSION

Deductions are a matter of legislative grace and the taxpayer bears the burden of proof to show that the deduction claimed is within the applicable statute. New Colonial Ice Co. v. Helvering, supra. See also Higgins v. C.I.R., T. C. Memo. 1984-330 (1984). The burden rests upon the taxpayer to disclose his receipts and claim his proper deductions. United States v. Ballard, 535 F.2d 400 (1976). 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). For the majority of the expenses under review in this matter, the taxpayer simply failed to produce the required receipts and other documentation required for the deduction. Therefore, the taxpayer must bear its misfortune and pay the additional tax associated with the disallowed deductions.

WHEREFORE, the Notice of Deficiency Determination dated April 14, 2008, is hereby MODIFIED, in accordance with the provisions of this decision and, as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

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

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
FY2005	\$7,463	\$ 373	\$1,628	\$ 9,464
FY2006	5,780	289	897	<u>6,966</u>
			TOTAL DUE	<u>\$16,430</u>

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

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

DATED this _____ day of _____, 2009.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2009, 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.