BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted] Petitioners.	)))))))	DOCKET NO. 21520 & 21880 DECISION

On August 26, 2008, the Idaho State Tax Commission's (Commission) Income Tax Audit Bureau (Bureau) issued a Notice of Deficiency Determination (NODD) to [Redacted] (taxpayers) proposing additional income tax, penalty, and interest for taxable year 2006 in the total amount of $582. Additionally, on that same day, the Bureau issued a second Notice of Deficiency Determination (Notice) to [Redacted] (Corp) for its taxable year ending June 30, 2007. The Corp [Redacted] had elected to be treated as a C corporation. The Notice issued to the Corp did not assert that any additional monies were due to or from the Corp.

The taxpayers and Corp (petitioners) filed a timely petition for redetermination. On June 16, 2009, the petitioners were informed of their appeal rights. An informal hearing was held on September 1, 2009. The Commission, having reviewed the file, hereby issues its decision.

In March 2007, the taxpayers filed an amended Idaho income tax return for taxable year 2006 seeking a refund of $120. The amended return was filed to claim additional expenses relating to the wife's sole proprietorship reported on federal Form 1040 Schedule C. The taxpayers attached the following explanation to the amended return:

Amended Return Reason Statement

[Redacted]

The Commission's records reflect that a refund check totaling $121.68 was issued to the taxpayers on July 4, 2007, and that the check was redeemed on July 10, 2007.

In 2008, the Bureau audited the taxpayers' Idaho income tax return for taxable year 2006 and the Corp's Idaho corporate income tax return for taxable year ending June 30, 2007.

The following table reflects the Idaho taxable income of the taxpayers as originally filed, as amended in 2007, and as adjusted in 2008 by the Bureau:

Table 1	Return	Adj.s	Amended	Adj.s	NODD
Wages, interest, pension	$42,587		$42,587		$42,587
State tax refunds	1,147		1,147		1,147
Husband's Sch. C. net profit	93		93		93
Wife's Sch. C net profit:					
Gross income	12,758		12,758		12,758
Car and truck expenses	(1,041)		(1,041)		(1,041)
Depreciation, insurance, meals	(530)		(530)		(530)
Legal and professional	(375)	($6,172)	(6,547)	$6,172	(375)
Supplies, meals, and entertainment	(317)		(317)		(317)
Other expenses	(2,302)		(2,302)		(2,302)
Business use of home	(3,038)	1,017	(2,021)		(2,021)
One-half self-employment tax	(364)	364	0		0
State and local taxes	(1,930)		(1,930)		(1,930)
Real estate taxes	(637)		(637)		(637)
Interest expense	(6,504)		(6,504)		(6,504)
Charitable contributions	(24,309)	2,395	(21,914)		(21,914)
Remove state tax refunds	(1,147)		(1,147)		(1,147)
Remove state income tax deduction	1,930		1,930		1,930
Personal exemptions	(6,600)		(6,600)		(6,600)
Idaho Taxable Income	$9,421	($2,396)	$7,025	$6,172	$13,197

The deduction for $6,172 of "[Redacted]" claimed by the taxpayers in their amended return resulted in the elimination of the deduction for one-half of self-employment taxes, as well as, reducing the amount for the use of the taxpayers' residence and charitable contributions.

When the Corp filed its return for taxable year ending June 30, 2007, the Corp reported management fee income of $12,979, rent expense of $12,974, and office supplies expense of $25; resulting in an Idaho taxable loss of $20. In the Notice issued to the Corp, the Bureau eliminated the $12,979 of gross receipts and the $12,974 of rent expense leaving an Idaho taxable loss of $25. No additional monies were due to or from the Corp as a result of the Bureau's actions.

In the Notice issued to the Corp, the Bureau removed the $6,172 of management fee income for the period July 1, 2006, through December 31, 2006, since the deduction was disallowed in the NODD issued to the taxpayers for taxable year 2006. Additionally, the Bureau disallowed the remainder of the management fee income the Corp had reported for the period January 1, 2007, through June 30, 2007, in the amount of $6,807, and the Bureau disallowed $12,974 of rent expense claimed by the Corp. The Bureau disallowed the rent expense since an accrual basis taxpayer cannot deduct rent expense paid to a related cash basis taxpayer until such time as the related taxpayer has reported the rent as rental income. The Bureau cited Public Law 98-369 as authority for its position.

The wife operated a [Redacted] business as a sole proprietorship. The wife's sole proprietorship was converted to and registered as an Idaho LLC [Redacted]. The LLC was treated by the taxpayers as a disregarded entity for [Redacted] income tax purposes. The disregarded LLC did not have any employees; however, a federal Form 1099-MISC was issued to one individual for nonemployee compensation. The wife reported the disregarded LLC's income and expenses activity as hers on her [Redacted].

The Corp was registered as an Idaho LLC in May 2006. The Corp elected to be treated for [Redacted] income tax purposes as a C corporation. On its [Redacted] income tax return, the Corp listed its business activity as management services and its product or service as management services. The Corp was wholly owned by the taxpayers.

The taxpayers, the disregarded LLC, and the Corp each had their own checking accounts. The checking accounts for the disregarded LLC and the Corp were both opened on the same day in July 2006 with the same bank.

The Corp would bill the disregarded LLC for management services reportedly performed by the taxpayers for the Corp. A check would be issued by the disregarded LLC from its bank account as payment for the management fee, and the Corp would deposit that check into its bank account. The management fee would be deducted on the wife's [Redacted], and the Corp would report the management fee as income on its corporate income tax return.

The Corp would bill the disregarded LLC for rent expense. The rent expense is supposedly for renting the personal residence of the taxpayers from the disregarded LLC. The Corp did not remit a cash payment to the disregarded entity for the rent since the Corp did not have the cash to make the payment. The Corp did not retain money in its bank account for any substantial period of time. Instead, and in almost every instance, as the management fee checks were deposited into its bank account, the Corp would write a check to the wife and indicate on the check that it was a loan to the wife. The checks written to the wife were, in most cases, for the exact same amount as the management fee. A promissory note between the wife and the Corp was executed in July 2007, well after the Corp issued the monthly checks to the wife.

Since the Corp files its returns on an accrual basis, the Corp claimed a deduction on its corporate income tax return for the rent expenses. The wife on her [Redacted] did not report any rental income since the disregarded LLC did not receive a cash payment from the Corp for the rental of the taxpayers' personal residence.

The Corp's corporate income tax return did not reflect other activity other than the recording of the management fee, the rent expense, and a minor amount of supplies.

In summary, the circular flow of cash created between the wife, the disregarded LLC, and the Corp can be demonstrated as follows:

[Redacted]

The circular flow of funds between the various checking accounts was circular money movements that began and ended with the wife, with no change in the economic position to the taxpayers. The circular flow results in a reduction in the amount of the wife's net profit from her sole proprietorship, which is subject to the federal self-employment tax, as well as a reduction in the [Redacted] and Idaho taxable income.

The arrangement the petitioners engaged in was provided to the petitioners by their current tax preparer. The tax preparer, who is also the representative for the petitioners, acknowledged at the informal hearing that the petitioners were following a tax structure that he had recommended to the taxpayers. The structure contained three phases as follows:

LLC Guidelines

I. Preliminary Requirements:

A. Set up Primary Business LLC
Set up Management LLC

B. Set up personal banking accountant
Set up Primary Business LLC banking account
Set up Management LLC banking account

C. Purchase pad of invoices or use computer generated invoices

II. From July 1 through December 31st:

A. If you want to transfer your profit, and/or take a "draw" for personal expenses, out of the Primary Business LLC, prepare an invoice for that amount as a "Management Fee" from the Management LLC to the Primary Business LLC

B. Write a check on the Primary Business LLC account to pay the "Management Fee" invoice

C. Deposit the Primary Business LLC checks in the Management LLC account

D. If you are taking a "draw", write a check on the Management LLC account to yourself, and in the "For" space, write "Loan to Owner"

E. Deposit your check into your personal checking account

III. From January 1st through June 30th

Add up the Management Fees for the Profit and the Draws from July 1st through December 31st of the previous year for the Primary Business LLC. Divide that amount by 6. This is the amount of "Rent" that your Primary Business LLC will invoice each month (January through June) to your Management LLC:

A. Prepare an invoice for "rent" each month from the Primary Business LLC to the Management LLC. The Management LLC can pay the invoice if funds are available.

B. If you take a "draw" out of the Primary Business LLC for personal expenses (from January through June), prepare an invoice for that amount as a "Management Fee" from the Management LLC to the Primary business LLC. IMPORTANT: Add the amount taken as a "draw" each month to the "Rent" invoice in Step A above.

C. Write a check on the Primary Business LLC account to pay the "Management Fee" invoice.

D. Deposit the Primary Business LLC check in the Management LLC account.

E. Write a check on the Management LLC account to yourself, and the "For" space, write "Loan to Owner."

F. Deposit the check in your personal checking account.

The taxpayers relied upon the preparer's structure converting the wife's existing sole proprietorship into the "Primary Business LLC" and creating the Corp as the "Management LLC." The taxpayers opened separate banking accounts for the LLCs in addition to their existing personal banking account. Monies flowed into and out of the various checking accounts as described above. The taxpayers created a paper trail that included computer generated invoices for management fees and rent expense; a promissory note as documentation for the loan to the wife by the Corp; computer generated single-page board minutes for the Corp as documentation for three board meetings; a management agreement between the disregarded entity and the Corp; a limited liability company authorization resolution form filed with the bank when creating the checking account for the disregarded LLC and the Corp; and various other documents relating to the creation of the disregarded LLC and the Corp.

In the petition for redetermination the petitioners' representative defended his arrangement as follows:

> Gregory v. Helvering, 293 U.S. 465(1935), was a landmark decision by the United State Supreme Court concerned with US income tax law. The case is cited as part of the basis for two legal doctrines: the business purpose doctrine and the doctrine of substance over form.
>
> Moline Properties, Inc. vs. Commissioner, 319 U.S. 436 (1943). The teaching of Moline is that so long as the entity carries on any business activity or the equivalent of any sort of business activity, the existence of the said entity will be recognized for tax proposes. Therefore, the form of a business entity will generally be accepted unless it can be shown that it is a sham and has no business activity.
>
> Thus, it has been stated that "a determination whether a corporation is to be considered as doing business is not necessarily dependent upon the quantum of business, and that the business activity may be minimal."
>
> Under case law, as well as under the regulations, an entity that is properly formed under state law to carry on a business following its formation must be recognized as an independent entity for tax purposes. Estate of Strangi vs. Comr., 115 T.C. 478(2000). 293 R. 3d 279 (5th Cir. 2002).
>
> Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury.

> There is not even a patriotic duty to increase one's taxes. Helvering vs. Gregory, 69 F. 2d 809, 810 (2d Cir. 1934).
>
> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands.
>
> The legal right of the taxpayer to decrease the amount of what otherwise would be taxes, or altogether avoid them, by means which the law permits, cannot be doubted. U.S. Supreme Court: Gregory vs. Helvering, 293 U.S. 465 (1935).

Subsequent to the issuance of the NODD to the taxpayers and the Notice to the Corp, the Bureau responded to each of the representative's arguments and raised new arguments against the arrangement. The petitioners were given an opportunity to respond to the Bureau's new arguments but declined to do so.

Included within the Bureau's new assertions is that the arrangement promoted by the petitioners' representative and employed by the petitioners, including the transactions themselves, lacked "economic substance" and should therefore be disregarded.

Preliminarily, any discussion of the economic substance doctrine must begin by noting the well-established "legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits" *Gregory v. Helvering*, 293 US 465, 469 (1935). The economic substance doctrine serves as a check on abuses of this principle by denying a taxpayer "tax benefits from a transaction that lacks economic reality" *Coltec Industries v. U.S.*, 454 F3d 1340, 1355 (Fed Cir 2006).

The Idaho Supreme Court has yet to apply the economic substance doctrine to an Idaho income tax case; however, this doctrine has a long history in federal case law. The Vermont Supreme Court recently reviewed the federal history of the economic substance doctrine.[1] A

[1] *TD Banknorth, N.A. v. Dep't of Taxes*, 967 A.2d 1148 (2008).

substantial portion of the Vermont court's analysis is incorporated in the following Commission discussion of the economic substance doctrine.[2]

The origin of this doctrine is the United States Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). The taxpayer in *Gregory* desired to sell stock shares held by a subsidiary. In order to minimize the taxes owed, the taxpayer had the stock that was to be sold transferred to her through a tax-free reorganization using a newly created separate corporate entity. After using the separate corporate entity in this manner, the taxpayer quickly dissolved it. Once the taxpayer owned the stock directly, she sold the shares, resulting in a far lower income tax assessment than if the original company had sold the shares. The Court dismissed the transaction as "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else," noting that the entity was put to death immediately following the sale of the stock. *Id.* at 470. Although the use of the new entity followed the strictures of the federal statute, which allowed for tax-free corporate reorganizations, the transaction was rejected as a sham because it had no relationship to legislative intent. The federal statute was passed to enable corporations to transfer assets "in pursuance of a plan of reorganization," not to facilitate tax avoidance. *Id.* at 469. While the Court noted that taxpayers have a legal right to act in a way that will decrease their tax burden, they may not do so by creating an entity with no other business or corporate purpose, but whose "sole object and accomplishment [is] ... the consummation of a preconceived plan" to avoid taxation. *Id.*

The most succinct statement of the economic substance doctrine by the United States Supreme Court occurs in *Frank Lyon Co. v. United States*, 435 U.S. 561, (1978). In that case,

[2] Courts have developed a number of closely related and sometimes overlapping doctrines that can be applied to negate claimed tax benefits in tax cases. These doctrines are often labeled differently by different courts. The Commission, like the Vermont court, labels the doctrine discussed herein as the "economic substance" doctrine, acknowledging that the authority cited does not consistently use this title.

the taxpayer purchased a building from a bank, financed mostly by a mortgage, and leased the building back to the bank for rent equal to the taxpayer's payments of principal and interest on the loan. The Supreme Court upheld the transaction, setting forth the following standard to determine when a transaction should be respected for tax purposes:

> [W]here ... there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.
> *Id.* at 583-84.

Federal appellate courts differ in their application of the economic substance doctrine. One version of the standard requires that for a transaction to be disregarded for tax purposes there must be both no business purpose other than to obtain tax benefits *and* no economic substance to the transaction. See *Horn v. Comm'r*, 968 F.2d 1229, 1237 (D.C.Cir.1992); *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir.1985). Other circuits indicate they will disregard a transaction if there is either no business purpose *or* no economic substance. See *Coltec Industries Inc. v. United States*, 454 F.3d 1340, 1355 (Fed.Cir.2006) ("While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."), *cert. denied,* 549 U.S. 1206, 127 S.Ct. 1261, 167 L.Ed.2d 76 (2007). Still, other circuits will ignore the taxpayer's motivation and focus primarily on whether the "transaction had any practical economic effects other than the creation of income tax losses." *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir.1988), *abrogation on other grounds recognized by Keane v. Comm'r*, 865 F.2d 1088 (9th Cir.1989); see also *James v. Comm'r,* 899 F.2d 905, 908-09 (10th Cir.1990). Alternatively, several circuits have held that both the business purpose and economic substance are related factors that "inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM Partnership v. Comm'r*, 157 F.3d 231, 247 (3d Cir.1998), *cert. denied*, 526 U.S. 1017, 119 S.Ct. 1251, 143 L.Ed.2d 348 (1999); see also *IES Indus., Inc. v. United States*, 253 F.3d 350, 353-54 (8th Cir.2001) (stating "we do not decide whether the [economic substance doctrine] requires a two-part analysis because we conclude that the [transaction] here had both economic substance and business purpose").

Whether a particular transaction has economic substance and business purpose other than the avoidance of taxes is primarily an issue of fact. See *Rice's Toyota World, Inc.*, 752 F.2d at 92.

During the Corp's taxable year from July 1, 2006, through June 30, 2007, the Corp billed the disregarded LLC 49 times for management fees totaling $12,974 and deposited the payments received from the disregarded LLC in the Corp's checking account. The monies paid to the Corp by the disregarded LLC were paid out of the bank account of the disregarded LLC. The Corp reported the management fees as taxable income, and as each payment was deposited into the Corp's bank account, the Corp would issue, immediately or shortly thereafter, a check to the wife for the amount of the management fee. This latter payment was characterized as a loan to the wife rather than a transaction that would result in taxable income to the wife. The taxpayers, when calculating their [Redacted] and Idaho taxable income, deducted that portion of the management fee paid in 2006 by the disregarded LLC totaling $6,172.

From January 1, 2007, through June 30, 2007, the Corp billed the disregarded LLC six times for rent expense totaling $12,979. The Corp deducted the rent expense when filing its federal and Idaho income tax return and completely offset the management fee income with the rent expense; however, as previously mentioned, the Corp never actually paid the disregarded entity the rent expense. Instead, the money was returned to the wife as a loan.

The Commission finds that the petitioners were involved in a circular flow of funds using multiple checking accounts between related entities that the taxpayers controlled. The circular flow of funds between the various checking accounts was circular money movements that began and ended with the wife, with no change in the economic position to the taxpayers. The circular flow results in a reduction in the amount of the wife's net profit from her sole proprietorship, which is subject to the federal self-employment tax, as well as a reduction in the taxpayers' federal and Idaho taxable income. The reporting of management fee income and expense, the rent expenses and the loan payments to the wife were transactions that had no non-tax business purpose and as such lacked economic substance. Courts have repeatedly held in so-called "circular check scheme" cases that taxpayers may not receive tax benefits based on checking arrangements that lack economic substance. See *Erhard v. Commissioner*, 46 F.3d 1470, 1477 (9th Cir.1995) (upholding Tax Court's finding that debt created when taxpayer-controlled corporations loaned money to each other in laundering "system" was a sham); *Goldberg v. United States*, 789 F.2d 1341, 1343 (9th Cir.1986) (same result involving the same tax advisor); *Thompson v. Commissioner*, 66 T.C. 1024, 1976 WL 3733 (1976) (same), aff'd, 631 F.2d 642 (9th Cir.1980), *cert. denied*, 452 U.S. 961, 101 S.Ct. 3110, 69 L.Ed.2d 972 (1981); see also *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir.1990) (upholding disallowance of three taxpayers' depreciation deductions for property leased to each other in a circle because their investments were not "at risk" under I.R.C. § 465).

In the Notice issued to the Corp, the Bureau eliminated the management fee income from the Corp's calculation of gross income and disallowed the Corp's rent deduction until such time as the taxpayers reported the rental income.[3] The Notice to the Corp is hereby modified consistent with the Commission's finding that the transactions engaged in by the Corp lacked economic substance and are to be disregarded. The disregarding of these transactions does not result in any additional monies owed to or by the Corp.

In the NODD issued to the taxpayers, the Bureau disallowed a deduction for $6,172 of management fees paid by the disregarded LLC to the Corp and claimed as a deduction on the wife's federal Form 1040 Schedule C since the Bureau found that the management fees were not ordinary or necessary business deductions. The NODD is hereby modified consistent with the Commission's finding that the management fee transactions lacked economic substance as well as to restore the reduction in the other expenses impacted by the disallowance of the management fees which results in an Idaho taxable income of $9,421, not $13,971, as shown in the NODD. The amount of additional tax sought would only be $120, not $362, as shown in the NODD. Interest due on the $120 is calculated in accordance with Idaho Code section 63-3045.

Based solely upon the facts in this docket, the Commission finds it appropriate to apply to the taxpayers' taxable year 2006 the Idaho Code section 63-3046(a) penalty rather than the Idaho Code section 63-3046(b) penalty as asserted in the NODD.

WHEREFORE, the NODD issued to the taxpayers dated August 28, 2008, and the Notice issued to the Corp dated August 28, 2008, is hereby MODIFIED, AFFIRMED, and MADE FINAL.

---

[3] Although the Commission is modifying the Notice issued to the Corp, the Commission is not conceding that the rent expense would be deductible by the Corp in the event that it is later found that the transactions have economic substance. Under Internal Revenue Code section 267(a)(2), the Corp would be required to wait until the taxpayers reported the income before the Corp can claim the rent deduction.

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

YEAR	TAX	PENALTY	INTEREST	TOTAL
2006	$120	$10	$20	$150

Interest is calculated through February 28, 2010, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

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

An explanation of the petitioners' 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.

____