BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 25498
[Redacted],	)	
	)	
Petitioners.	)	DECISION
	)	

BACKGROUND

On November 1, 2012, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted](Petitioners) proposing income tax, penalty, and interest for taxable years 2008 through 2011, in the total amount of $8,241. On January 2, 2013, the Petitioner's CPA filed a timely protest. A modified NODD was sent on May 24, 2013. The remaining balance due for income tax, penalty, and interest was $7,440. The file was transferred to Tax Policy on June 26, 2013, for resolution. On July 25, 2013, the Commission sent the taxpayer a letter that explained the methods available for redetermining an NODD.

ISSUES

1. Whether certain business expenses are ordinary and necessary to [Redacted] business as a [Redacted]. Specifically, whether the Petitioners met the substantiation requirements to deduct certain meals, computer repairs, internet service, mileage, and payments to an employee benefit program established for [Redacted].

2. Whether the Petitioners received a taxable distribution in 2011, from [Redacted].

3. Whether payments made by the Petitioners qualify as deductible gifts to charity.

4. Whether the negligence penalties asserted are appropriate in this audit.

DISCUSSION

The audit began with some questions about a real estate installment sale that was being reported by the Petitioners. When the CPA responded, the auditor expanded the audit to include questions about the Petitioner's business expenses for his self-employment income reported on his [Redacted]Schedule C. The CPA response to some of the items was sufficient for Audit to modify the NODD. The others were reviewed during the redetermination process.

First Issue – Whether certain business expenses are ordinary and necessary to the Petitioner. Audit first raised the question of what are ordinary and necessary business expenses for a [Redacted], as defined in Internal Revenue Code (IRC) section 162.

As a secondary issue with the business expenses, Audit required substantiation of all the business expenses claimed. After examination of the documentation provided, Audit accepted the business organization memberships and the majority of the mileage, but did not allow the employment of [Redacted] or the medical reimbursement plan, the computer repairs, and internet service.

The Petitioner provided a written statement by a fellow member of the [Redacted] board. The letter explains in detail the duties of a member of the board. He explains why the Petitioner, as Chairman of the board, is expected to participate in the local [Redacted]. He corroborates the requirement for high speed secure computer access. This type of computer repair work is indicative of more than a casual use of the computer and fits with the letter of corroboration. The receipt, when taken in conjunction with the letter of corroboration from the other board member and other evidence in these circumstances, establishes the business purpose.

Business gifts. Audit limited the amounts claimed for business gifts to the $25 limit under IRC section 274(b). However, Treasury Regulation 1.274-3(c) defines the expense of a gift as not including the wrapping, shipping, and other incidental costs as long as they do not add to the value of the gift, and therefore, are not subject to the limitation. 1.274-3(e)(2) says that gifts to a corporation or other business entity is not subject to the limitation. The shipping costs on all the gifts are allowed. The $100 gift of flowers to the [Redacted] is allowed.

Employee benefit program. Audit questioned the validity of [Redacted] as an employee and therefore the payments made to the employee benefit program established under IRC 105. The Petitioner did establish a bona fide plan with [Redacted], [Redacted]. There were administrators appointed and paid during 2009, although there is no requirement to have outside administration. The Petitioner provided copies of an employment contract, copies of W-2s and the net paycheck paid to [Redacted]. The payroll taxes were calculated and paid.

Establishing whether specific work was performed, and whether that activity rose to the level of an employee, can be difficult and may be subjective. The Commission declines to pursue the issue any further.

Second issue – Whether the taxpayer had a gain on liquidation of the [Redacted], a family limited liability corporation (LLC). In 2006, the Petitioners created a family limited liability corporation to hold some real estate and for estate planning. [Redacted] elected to file as a partnership for income tax purposes. The Petitioners owned 96 percent and their children owned the remaining 4 percent. In 2011, the Petitioners planned to sell the property. While preparing for the sale, the Petitioner discovered that the larger parcel of the property was never actually transferred into the LLC. The legal description of the property owned by the LLC was only an alleyway that ran behind the main property. The Petitioners purchased the alleyway from the LLC to enable them to sell the entire property. The LLC reported the gain on the sale of the alleyway to each member in their distributable share. The Petitioners reported their portion of the gain on their individual return and paid the taxes on that. The sale of the entire property to the outside buyer could then proceed as a sale from the Petitioners as individuals.

The LLC was dissolved and the final return was filed. During the protest process, the Petitioner provided a copy of the partner basis calculation of the 2011, LLC tax return. The basis calculation shows that the Petitioners contributed cash during the last year that accounts for the proposed gain.

Audit questioned whether the Petitioners met the holding period on the 4 percent of the property that was believed to have been contributed to the partnership and later distributed to the Petitioners. The Commission accepts that the larger portion of the property was not contributed to or distributed from the partnership. Therefore, the Petitioners have met the holding period to qualify for long term capital gain treatment and the Idaho Capital Gain Deduction.

There were a couple of adjustments to the amount of the Idaho deduction. One was a subtraction mistakenly taken directly as an Idaho subtraction and entered on the Capital Gain Deduction worksheet. That subtraction was reversed. The other correction was to the gain used on the deduction worksheet. It was 60 percent of the gain, and should have been the total gain the Petitioners reported from the sale of the alleyway. These corrections were made in calculating the final amount due.

Third issue – Personal deductions and exemptions. There are a couple of sub-issues to this category as well. The Petitioners claimed the standard deduction for the years 2009 and 2010.

One is whether the Petitioners met the substantiation requirements to qualify deductions claimed as gifts to various charities. The other was the change to the amount of itemized deductions affected by the phase out limitations on the [Redacted] return. In the modified NODD, Audit accepted the majority of the contributions claimed and accepted some as business expenses instead of charitable.

CONCLUSION

First issue – Whether the Petitioner is entitled to deduct various self-employed business expenses. The Commission has reviewed the information in the file and provided during the protest review process, and accepts the Petitioners' position on the majority of the business expenses as reported either on the original return or as discussed in the protest process.

Second issue – Gain on Liquidating Distribution. Whether the Petitioners received a taxable distribution in 2011, from [Redacted]. The basis worksheet provided during the protest period showed the amount of additional cash contributed to the partnership, and therefore there was no gain.

Third issue - Whether payments made by the Petitioners qualify as deductible gifts to charity. The auditors accepted the majority of the charitable contributions. Some of the items were identified as more properly allowed for a business deduction by Audit. No further adjustments were made.

Fourth issue – Penalties. The Commission agrees that the penalties be waived in this case.

THEREFORE, the Notice of Deficiency Determination dated November 1, 2012, corrected on May 24, 2013, and directed to [Redacted] is hereby AFFIRMED as Modified.

YEAR	TAX	REFUND	INTEREST	TOTAL
12/31/08	$ 0	$ (45)	$ (9)	$ (54)
12/31/09	82	0	11	93
12/31/10	0	(161)	(15)	(176)
12/31/11	1,856	0	99	1,955
				1,818

Interest is calculated through October 31, 2013, 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 ___________________ 2013.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of ___________________ 2013, 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] Receipt No.

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