

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

In the Matter of the Protest of	)	
	)	DOCKET NO. 25639
[Redacted],	)	
	)	
Petitioner.	)	DECISION
<hr style="width: 35%; margin-left: 0;"/>	)	

BACKGROUND

On March 29, 2013, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioner) proposing adjustments to the Idaho taxable income for the taxable year 2008 and the tax year ending September 30, 2009. [Redacted] is a Subchapter S corporation<sup>1</sup> (S corp.). Any adjustments to the income or expense items on an S corp. flow directly through and are reported on the shareholders' individual income tax returns. A separate NODD was prepared and issued to the shareholders, see Docket No. 25638. Audit questioned some of the expenses on the 2008 return and discovered that there was no return filed for 2009. The 2009 return was originally due on April 15, 2010, it was filed late on May 24, 2012. The 2009 tax return was for a short year ending September 30, 2009, due to the sale of the corporation.

On May 29, 2013, the Petitioner's attorney-in-fact, under authority of an Idaho Power of Attorney (POA), filed a timely protest. On September 12, 2013, the file was transferred to the Legal/Tax Policy Division for resolution. A letter was sent on October 17, 2013, explaining the options for resolving an appeal.

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<sup>1</sup> Under federal law, S corporations permit shareholders to elect a pass-through taxation system under which income is subjected to only one level of taxation; the corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholders' individual tax returns. Internal Revenue Code, subchapter S.

## ISSUES

1. The disallowance of expenses claimed on the tax return primarily for lack of or inadequate documentation and not establishing the business purpose<sup>2</sup>.

Specific categories are as follows:

- a. Unsubstantiated business expenses including cost of goods sold, office supplies, repairs, marketing, and utilities.
- b. Travel and entertainment.
- c. Listed property expenses.
- d. Meals and whether the log book or diary was sufficient to establish the business purpose.
- e. Business mileage and whether the log book or diary supported the business purpose.
- f. Expenses related to [Redacted], a separate business activity that was reported on federal schedule C on the owner's income tax return outside of the S corp.

## DISCUSSION

This file was referred to audit by the Tax Discovery Bureau (TDB) of the Idaho State Tax Commission for questions on the 2008 corporation income tax return and the fact that the 2009 return was late and had not been filed at that point. The POA was replaced a few times during the audit and appeal process.

The total adjustments in the NODD were \$110,147 for 2008 and \$133,416 for 2009. Those adjustments were reflected on the NODD of the shareholders. A portion of the 2008

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<sup>2</sup> Internal Revenue Code (IRC) section 6001, ID Code section 63-3075 & Administration and Enforcement Rule A410.

expenses, \$6,802 was allowed on the shareholders return as an adjustment to the Schedule C business, so the net increase in taxable income related to the corporation expenses was \$103,345.

**a. Unsubstantiated expenses:**

**Audit's Position:**

The shareholders submitted a large volume of receipts to substantiate the claimed expenses. However, many of the entries on the general ledger are listed as "Miscellaneous Vendor". We have sent the receipts back to the shareholders and requested that they organize them and identify all of the claimed expenses on the ledger. This was not done. After a summons was issued to the shareholders to produce the Quick Books ledger, we proceeded with identifying the expenses that had a vendor name that we could associate with a receipt. The audit work papers were then provided to the shareholders with a key code listed on each page as to the reason the expense was disallowed. The shareholders were given additional time to provide substantiating documentation. The material they provided with this additional time consisted of bank statements and an appointment book. Individually or taken together, the items they provided do not meet the substantiation requirements of IRC Section 274 for Travel & Entertainment expenses. Examination of the submitted receipts show that these are not business expenses but personal, family, living expenses.

**Policy review:**

When the case was transferred to the Legal/Tax Policy Division for the appeal process, 4 boxes of information were sent along with it. The information was not very well organized and there were documents that were not relevant to the disallowed items. The tax policy specialist requested that the POA try to structure the information better to answer the questions at hand. The POA made a statement that they were certain a very high percentage of the expenses were valid and should be accepted. However, the shareholder called and wanted to prove all of the expenses claimed and wanted more time in which to do that.

Another new representative was introduced to us and a valid Idaho Power of Attorney Form was filed. In June of 2015, the new CPA sent a set of indexed copies of receipts that corresponded to some of the disputed expenses. The information provided was only for a

fraction of the total audit adjustments. It was obvious that the CPA had not been provided a copy of the original NODD. The tax policy specialist sent copies of the NODDs of both the corporation and the shareholders to the POA. The tax policy specialist assisted by retrieving copies of some tax documents that had been filed with the Commission, like 1099s to prove the payments to subcontractors.

The repackaged and re-indexed documentation was received in September 2015, during the policy review process. The receipts were reviewed along with the Day Timer calendar books that were submitted as support for the business miles and business purpose for meals.

Eventually, there was a large amount of information provided. However, the quantity did not make up for the lack of quality. There are a few systemic problems with the Petitioner's records. In spite of being a corporation, the Petitioner regularly uses the personal checking account and personal credit cards of the shareholders. Expenses that are clearly personal are paid from the same checking account as business expenses including the personal credit cards of the shareholders making it more difficult to determine the business purpose of expenses. Payment of the personal credit cards, to the extent that they were paying for personal expenses should have been tracked and reported as distributions from the S corp.

Several of the documents provided are in the name of other entities. It is well established in law that a taxpayer cannot claim the expense of another<sup>3</sup>. The shareholder owned a C corporation that last filed an Idaho corporation income tax return for the 2006 taxable year. That corporation, [Redacted], had a separate EIN and never filed a final return with the state of Idaho. The Petitioner argues that the common ownership is enough to prove that documents with that prior corporation are valid tax deductions of the current S corp. The Petitioner argues the fact that if another corporation's name is used on a vendors receipt is unimportant. The

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<sup>3</sup> Zavadi v Commissioner 793 F.3d 866.

Commission disagrees; we are not able to disregard the corporate structure that exists. A third corporation, [Redacted], filed a DBA reserving the name “[Redacted]” with the Idaho Secretary of State on August 21, 2008. When reviewing the payments made to the Nevada Secretary of State, we discovered that “[Redacted]” was a domestic corporation, registered by the shareholders and was dissolved on December 31, 2008. Normally, we would expect [Redacted], as a separate corporation doing business in Idaho, to file its own Idaho income tax returns.

The comingling of expenses makes it impossible to distinguish expenses like repairs to the office from repairs made to the shareholders rental property or home. Expenses that were substantiated, were accepted and the NODD adjustment was reduced accordingly. *See* the summary table at the end.

**b. Travel and entertainment:**

During the 2 year audit period, the shareholders took seven trips to various other states. The trips were approximately a week long each and both shareholders went on most of them. There was no attempt to separate any personal aspect of these trips even though they are all in common vacation destinations. There is no direct evidence of any customers in those cities except small residual payments left over from customers of a predecessor corporation that was owned by the shareholders. The total amount of income, based on the documentation provided, is \$267.36 during 2008 and \$177.99 during 2009. The sample contracts provided as evidence that they had customers in Hawaii were not signed. The total travel expense during that same period was almost \$11,500. “Section 274(d) requires petitioner to substantiate the amount of the expense and the time and place of the travel, which he has done. Additionally, petitioner must show, by adequate records or sufficient evidence corroborating his own statement, the business

purposes of the expenses, which he has not done<sup>4</sup>.” The out of town travel was not accepted.

**c. Listed property expenses:**

Some of the adjustments in the NODD were because of the classification as listed property. The nature of listed property lends itself to both business and personal uses and therefore requires a higher threshold of documentation. This is the definition of listed property from IRS Publication 534, Listed Property. Listed property is any of the following:

1. Any passenger automobile,
2. Any other property used for transportation,
3. Any property of a type generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video recording equipment),
4. Any computer and related peripheral equipment, defined later, unless it is used only at a regular business establishment and owned or leased by the person operating the establishment. A regular business establishment includes a portion of a dwelling unit (defined later), if, and only if, that portion is used both regularly and exclusively for business as discussed in Publication 587.
5. Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

The documentation provided was mostly either a receipt or a credit card statement showing an expense. Several were estimates or quotes; some documents were printed from QuickBooks making it difficult to verify that they came from a vendor. Very few items claimed had both a receipt to show what was purchased and a bank or credit card statement to prove when and how much was paid.

**d. Business meals:** The Petitioner’s meals were included with the Travel and Entertainment amount on the tax returns. After reviewing the documentation submitted, using the Daytimer Calendar books for substantiating the business purpose, we allowed \$2,016 for 2008 and \$1,080 for 2009. Meals were allowed at 50 percent<sup>5</sup> in keeping with the Internal Revenue Code (IRC).

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<sup>4</sup> Thomas J. Barnes, TC Memo 1992-720.

<sup>5</sup> IRC 274(n)(1)

**e. Business mileage:**

Business mileage was accepted based on the Day Timer calendar books that were submitted as mileage logs. We agreed to allow the standard mileage rate for business miles in the amount of \$2,365 for 2008 and \$3,555 for 2009.

**f. Expenses related to Schedule C business:**

Some of the expense documents provided as support for the corporate tax deductions were related to the equipment used in the business reported on the shareholder's income tax return. The largest adjustment on the NODD was for the depreciation expense. On the original S corp. income tax return, the total equipment amount on the Form 4562 was \$238,267. The depreciation expense claimed was in the amount of \$39,337 for 2008 and \$24,701 for 2009. There was no equipment list included with the tax return. When the Petitioner provided an equipment list during audit the total value of the equipment was only \$135,902.60. Following the Modified Accelerated Cost Recovery System (MACRS), all personal property, that is, other than real property, the half-year convention is required. There is an election whether to use the percentage tables or to use the straight line methods<sup>6</sup>. The Petitioner elected to use straight line and once made the election is irrevocable. The depreciation was disallowed on the S corp. tax return and the corrected amount was allowed on the shareholder's NODD.

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<sup>6</sup> Internal Revenue Code section 168(d)(4)(A).

**Summary of NODD adjustments:**

<b>Taxable Years</b>	2008	09-30-2009
Expenses claimed on returns.	\$233,991	\$186,933
Adjustment to gross income.	(874)	0
Allowed by audit.	(122,970)	(53,517)
Adjustment on NODD.	110,147	133,416
Additional expenses allowed by appeal.	(16,224)	(32,094)
Standard mileage rate allowed for business miles.	(2,365)	(3,555)
Modified adjustment to shareholders NODD.	91,558	97,767
<b>Adjustments allowed to the shareholder's NODD:</b>		
Schedule C expenses allowed by audit on shareholder's NODD.	(6,802)	

A Notice of Deficiency Determination issued by the Idaho State Tax Commission is presumed to be accurate. Parsons v. Idaho State Tax Commission, 110 Idaho 572 (Ct. App. 1986). The burden is on the taxpayer to show the deficiency is erroneous. Albertson's, Inc. v. State, Dept. of Revenue, 106 Idaho 810 (1984).

THEREFORE, the NODD dated March 29, 2013, and directed to [Redacted] is hereby AFFIRMED as MODIFIED herein.

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2016.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2016, 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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