

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

In the Matter of the Protest of )  
[Redacted] ) DOCKET NO. 1-786-540-032  
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Petitioners. ) DECISION  
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Audit staff issued a Notice of Deficiency Determination on October 14, 2016, adjusting Petitioners’ return because, 1) the figures on Petitioners’ returns did not match their corresponding general ledgers, 2) Petitioners, who regularly used cash-basis accounting to calculate their income, used entries on their books to start 2010 with negative income, and 3) a number of expenses claimed on Petitioners’ 2010 and 2011 Schedule C were not sufficiently substantiated.[Redacted]

(Petitioners) protested the Notice of Deficiency Determination. Petitioners argued that the auditor refused to recognize or give credence to the inability of Petitioners to produce receipts or similar items for expenses because the records were destroyed. In addition, Petitioners argued that zeroing out the entries that caused 2010 to start with negative income would impose an inappropriate double-tax on the same income. The Audit staff, after receiving some additional substantiation from Petitioners, adjusted and allowed for additional expenses in its Modified Notice of Deficiency Determination dated January 20, 2017. However, Audit staff reaffirmed that both the general ledger-to-return adjustments and the zeroing out of Petitioners’ negative income starting out the year 2010 were proper. The Tax Commission now upholds the Modified Notice of Deficiency Determination and the penalties assigned by the Audit staff.

**BACKGROUND**

Audit staff were presented with multiple issues during their review of Petitioners’ records. Audit staff identified that Petitioners’ general ledgers did not match the amounts on their 2010 and

2011 returns. Second, Petitioners, who regularly use cash basis accounting to calculate their income, decreased their 2010 Schedule C business income through journal entries to offset income they over-reported in tax year 2009. Lastly, Audit staff also discovered a number of expenses claimed on Petitioners' 2010 and 2011 federal Schedule C that were not sufficiently substantiated. Audit staff, accordingly, issued a Notice of Deficiency Determination dated October 14, 2016, which included the negligence and substantial understatement penalties.

Petitioners in their protest reserved their right for a hearing. Petitioners also provided with their protest a schedule that specifically provided the factual and legal basis for the protest of various items. The last item on this schedule is a protest against "the book to return adjustments" (i.e. the Audit staff's adjustments based on the general ledgers provided by Petitioners' CPA). Petitioners' protest for this item indicated, in essence, that Petitioners had no knowledge of the additional income discovered in the general ledger provided by their CPA. But Petitioners did not object to the validity of the general ledgers provided by their CPA.

Petitioners' protest also included additional substantiation documents. The protest argued that Petitioners' records were destroyed in an office flood and that the Tax Commission should be open to secondary evidence for the substantiation of these expenses. The protest indicated that Petitioners were compiling secondary evidence and would submit this evidence in an organized fashion.

The protest also argued that Audit staff's adjustment to their 2010 income would cause an inappropriate double-tax. From Commission records, it appears that Petitioners included their accounts receivable line item in their 2009 return. After which, in 2010, rather than amending their 2009 return to correct 2009's income, Petitioners instead made journal entries that started off the 2010 year with a negative income that accounted for 2009's over-reporting of income.

The Audit staff modified the original Notice of Deficiency Determination to reflect the additional expenses that were substantiated by the documentation sent with Petitioners' protest and a Modified Notice of Deficiency Determination was issued to Petitioners on January 20, 2017. No additional substantiation was received or discovered by the Tax Commission. In addition, despite multiple attempts by Audit staff to obtain the additional documentation described in Petitioners' protest, Petitioners remained unresponsive. Therefore, Audit staff referred the matter for administrative review.

## **LAW & ANALYSIS**

### **1. Book to Return Adjustments**

In Idaho, a State Tax Commission deficiency determination is presumed to be correct. The burden is on the taxpayer to show that the deficiency is erroneous. *Parsons v. Idaho State Tax Commission*, 110 Idaho 572, 574-575 n.2, 716 P.2d 1344, 1346-1347 n.2 (Ct. App. 1986).

Audit staff's review of Petitioners' records identified that Petitioners' accounting records (general ledgers) did not match the amounts on their 2010 and 2011 income tax returns. Petitioners' CPA indicated to the Audit staff that it was likely that someone from Petitioners' office had modified the general ledgers after the returns for 2010 and 2011 had been filed. Petitioners' CPA restored the ledgers. The Audit staff used this restored version to make the adjustments to Petitioners' returns. Petitioners' made no argument in their protest about the use of these general ledgers provided by Petitioners' CPA. Therefore, the determination by Audit staff is presumed to be correct and these adjustments are affirmed.

### **2. Accrual to Cash Adjustment**

Idaho Code § 63-3002 adopts the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income. The Internal Revenue Code recognizes that no uniform

method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. 26 C.F.R. § 1.446-1(a)(2). Taxable income is then computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. 26 C.F.R. § 1.446-1. Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner of the Internal Revenue Service. 26 C.F.R. § 1.446-1(e)(2)(i). A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. 26 C.F.R. § 1.446-1(e)(2)(ii)(a). A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. 26 C.F.R. § 1.446-1(e)(2)(ii)(a). Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method. 26 C.F.R. § 1.446-1(e)(2)(ii)(a).

Here, Petitioners, at the start of the 2010 year, clearly switched from a cash basis method of accounting—the method by which they “regularly compute their income”—to an accrual method of accounting when they started the year with a journal entry that created a negative income balance. Furthermore, this switch was conducted without prior notice to the Internal Revenue Commissioner. Therefore, the adjustment by Audit staff that zeroed out this negative income was appropriate. Petitioners argued in their protest that this adjustment would impose on Petitioners an inappropriate double-tax on the same income. However, Petitioners do not concede that they should have amended the 2009 return, rather than switch accounting methods at the start of 2010, in order to remedy their over-reporting of income in 2009. A switch in accounting methods,

without notice, is not allowed. Therefore, the Audit staff's adjustment zeroing out Petitioners' 2010 negative income is affirmed

### **3. Adjustments for Unsubstantiated Expenses**

Idaho Code § 63-3002 adopts the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income. Internal Revenue Code § 162(a) states, in part, that “[T]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” However, deductions/expenses are a matter of legislative grace and only as there is clear provision therefore can any particular deduction be allowed. *New Colonial Ice Co., Inc. v. Helvering*, 292 U.S. 435, 54 S.Ct. 788 (1934). The petitioner bears the burden of proving that he is entitled to the deduction. *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). Moreover, it is well established that the Tax Commission is not required to accept self-serving testimony in the absence of corroborating evidence. *Niedringhaus v. Commissioner*, 99 T.C. 202, 212 (1992); *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). 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).

However, Treasury Regulations § 1.274-5T(c)(5) makes provision for expenses relating to travel, entertainment, gifts, and listed property where the loss of taxpayer records were due to circumstances beyond the control of the taxpayer. The taxpayer must establish that the failure to produce adequate records was because of circumstances beyond the taxpayer's control, such as destruction by fire, flood, earthquake, or other casualty. If this is shown, the taxpayer has the right to substantiate a deduction by reasonable reconstruction of his expenditures.

Petitioners here have failed to produce sufficient substantiation, despite the amount of time allowed for them to produce the substantiation. Thus, Petitioners have failed to meet their burden. Petitioners argued that primary evidence substantiating several expenses in both 2010 and 2011 were destroyed in an office flood, therefore, the auditor should have been open to secondary evidence to be introduced. Petitioners provided with their protest some secondary evidence with a note in their protest that they planned to provide additional, organized substantiation for the Tax Commission to review. Considering the secondary evidence submitted with Petitioners' protest, the auditor modified the Notice of Deficiency Determination. No additional substantiation has been received from Petitioners or discovered by the Tax Commission. Therefore, the Audit staff's disallowance of multiple expenses in the Modified Notice of Deficiency Determination dated January 20, 2017 is affirmed.

#### **4. Penalties**

The Audit staff's assignment of the negligence penalty is affirmed. "If any part of any deficiency is due to negligence or disregard of rules but without intent to defraud, five percent (5%) of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency." Idaho Code. § 63-3046(a). An example situation that justifies the penalty includes a taxpayer's failure "to maintain proper records and file returns containing unsubstantiated claims or substantial errors." IDAPA 410(2)(b).

The information before the Tax Commission shows that Petitioners both failed to maintain proper records and have filed returns containing unsubstantiated claims and substantial errors. Petitioners' received from their CPA the appropriate "books" that could be used to compose their returns. However, Petitioners' failed to use these resources and instead composed returns that substantially misreported their income for 2010 and 2011. Moreover, Petitioners filed returns that

contained unsubstantiated claims, such as the disallowed deductions that were not supported by primary, secondary or corroborating substantiation.

The substantial understatement penalty assigned by Audit staff is also affirmed. “If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent (10%) of the amount of any underpayment attributable to such understatement.” Idaho Code § 63-3046(d)(1). There is a substantial understatement when “the understatement for the taxable year exceeds the greater of [t]en percent (10%) of the tax required to be shown on the return for the taxable year, or [f]ive-thousand dollars (\$5,000). Idaho Code § 63-3046(d)(2).

Petitioners’ reported \$2,304 and \$16,588 income tax liability for the 2010 and 2011 years, respectively. The corrected income tax liability totaled \$20,410 for 2010 and \$27,115 for 2011, corrections, respectively, that totaled \$18,106 and \$10,527. These corrections far exceeds 10% of the tax required for each year and \$5,000. Therefore, Audit staff’s assignment of the substantial understatement penalty is affirmed.

### CONCLUSION

Wherefore, for the reasons mentioned above, the Tax Commission upholds the Notice of Deficiency Determination.

THEREFORE, the Modified Notice of Deficiency Determination dated January 20, 2017, and directed to [Redacted] is AFFIRMED.

IT IS ORDERED that Petitioners pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2010	\$18,106	\$2,716	\$5,104	\$25,926
2011	10,527	1,579	2,544	<u>14,650</u>
			TOTAL DUE	<u>\$40,576</u>

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

An explanation of Petitioners' right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2018.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2018,  
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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