

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
)
) DOCKET NO. 0-249-271-296
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) Petitioners.)
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(Petitioners) protested the Notice of Deficiency Determination (Notice) dated February 21, 2025, issued by the Income Tax Audit Bureau (Bureau) for tax years 2021 through 2023. Petitioners disagreed with the Bureau’s adjustments to their Schedule C expenses. The Idaho State Tax Commission (Tax Commission) reviewed the matter and for the reasons stated below modifies the Notice.

BACKGROUND

Petitioners were Idaho residents and timely filed their Idaho resident income tax returns for the years under review. Petitioners’ returns included three Schedule C businesses: () () and (). For tax year 2021, Petitioners reported expenses separately for each business. For tax year 2022, Petitioners combined () expenses with () and reported them on () Schedule C. For tax year 2023, all expenses were reported on () Schedule C. The Bureau selected Petitioners’ returns for review and requested they substantiate the business expenses reported on their Schedule Cs. Petitioners’ representative responded to the Bureau’s request, stating that, for tax years 2021 and 2022, Mr. () scanned and saved all their receipts on his laptop, but it was stolen. Therefore, Petitioners’ representative attempted to substantiate Petitioners’ business expenses by providing a summary of their expenses and bank statements. The Bureau reviewed all available information and found that it was not adequate or sufficient to prove the expenses

Petitioners reported were “ordinary and necessary” costs of carrying on their businesses. The Bureau then requested the representative provide Mr. [REDACTED] travel logs and an explanation of the business reason for each expense. The Bureau did not receive the requested information and therefore disallowed the Schedule C expenses and issued a Notice.

The representative protested and argued that all the Schedule C expenses are legitimate business expenses. The representative further argued that, even if the Bureau’s adjustments were appropriate, those adjustments would have affected Petitioners’ deductions of qualified business income (QBI) and self-employment (SE) tax, and those adjustments were not shown in the Notice. The representative’s final objection is that there is no justification for the penalties or the additional interest asserted in the Notice. The Bureau acknowledged the representative’s protest and sent the matter to the Tax Commission’s Appeals Unit (Appeals) for administrative review.

Appeals reviewed the case and sent Petitioners and the representative a letter explaining the options available for redetermining a Notice. The representative responded but did not request an informal hearing nor did they provide additional information.¹ The Tax Commission, having reviewed the file, hereby issues its final decision.

ISSUES

The issues for decision are -

- Petitioners’ Schedule C expenses, whether they are legitimate business expenses,
- If the Bureau’s Schedule C adjustments are determined to be appropriate, whether Petitioners’ deductions for SE tax and QBI should be adjusted, and
- Negligence penalty and interest, whether they are applicable.

¹ Appeals requested the representative provide Mr. [REDACTED] travel logs and the [REDACTED] board meeting minutes but did not receive it.

LAW AND ANALYSIS

Schedule C expenses

IRC section 162 provides for the deduction of all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. Idaho Code section 63-3042 allows the Tax Commission to examine a taxpayer's books and records to determine the correctness of an Idaho income tax return. Tax Commission Administration and Enforcement rule IDAPA 35.02.01.201 provides that, "A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability."

Deductions are a matter of legislative grace, and a taxpayer bears the burden of proving that he is entitled to the deductions claimed. *New Colonial Ice Co., Inc. v. Helvering*, 292 US. 435, 440, 54 S.Ct. 788 (1934). Taxpayers are required to maintain records that are sufficient to enable the determination of their correct tax liability. See IRC section 6001; Treasury Regulation section 1.6001-1(a). The burden rests upon the taxpayer to disclose his or her receipts and claim his or her proper deductions. *United States v. Ballard*, 535 F.2d 400, 404 (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 or her misfortune. *Burnet v. Houston*, 283 U.S. 223, 51 S.Ct. 413 (1931). A taxpayer's general statement that his or her expenses were incurred in pursuit of a trade or business is not sufficient to establish that the expenses had a reasonably direct relationship to any such trade or business. *Near v. Commissioner of Internal Revenue*, T.C. Memo. 2020-10 (2020).

In the protest, the representative cited *Cohan v. Commissioner* 39 F.2d 540 (2nd Court of Appeals 1930), which is a seminal case that established the "Cohan rule". The Cohan rule has been widely cited and applied in various court cases, allowing courts to estimate deductible amounts

when precise records are lacking if there is a reasonable and evidential basis. In the Cohan case, the court clarified that the record must at least establish the possibility of approximating the amount and provide a method for doing so. However, the Cohan rule has been superseded by the federal statute for certain expenses, i.e. travel expenses, including meals and lodging, entertainment expenses,² business gifts, listed property expenses,³ and charitable contributions, as Internal Revenue Code section 274(d) and its implementing regulations require strict substantiation.⁴ These rules explicitly state that no deduction shall be allowed based on approximations or unsupported testimony, thereby overriding the Cohan rule for these expenses. Treasury Regulation section 1.274-5T(a) and related guidance further clarifies that the Cohan rule does not apply for travel and entertainment expenses, and deductions should be disallowed unless the taxpayer meets the specific substantiation requirements set forth in the regulations.⁵

The Tax Commission now reviews the expenses claimed for the three businesses, [REDACTED]

[REDACTED] and [REDACTED] which were primarily operated by Mr. [REDACTED]

[REDACTED] and [REDACTED]

Travel, entertainment, gifts, and listed property expenses

In the protest, the representative explained that, for these two businesses, Mr. [REDACTED] provided review, assessment, and purchase advice, as well as financing options for corporate clients who are seeking to purchase and resell properties. Mr. [REDACTED] travelled to other states,

² The Tax Cuts and Jobs Act of 2017 eliminated the deduction for business-related entertainment expenses, but before the law changed, these expenses were also subject to strict substantiation requirements.

³ i.e. passenger vehicles, certain other transportation property, and property used for entertainment, recreation or amusement. Their business use must be documented.

⁴ For these expenses, the Internal Revenue Service requires proof or detailed contemporaneous records. As such, taxpayers must maintain adequate records or sufficient corroborative evidence to substantiate each element of the expenditure, such as amount, time, place, and business purpose.

⁵ Taxpayers must maintain adequate records or sufficient corroborative evidence to substantiate each element of the expenditure, such as amount, time, place, and business purpose.

inspected properties and provided advice to clients for potential property purchases. Mr. [REDACTED] spent significant amount of travel expenses, i.e., Car and Truck, Travel, and Meal, to visit his clients within and outside Idaho. Since the representative did not provide Mr. [REDACTED] travel logs to the Bureau, Appeals followed up on it with the representative. Appeals also requested the representative provide a list of Mr. [REDACTED] clients and their contact information, i.e. clients' names, addresses, and phone numbers. The representative responded, stating that they submitted all available information and requested the Tax Commission make a final decision based on that information.

As previously mentioned, the Cohan rule is not applicable to travel expenses, meals, gifts, entertainment expenses, and listed properties, as they are subject to strict substantiation requirements under IRC section 274(d). The Tax Commission reviewed the information provided by the representative and found that none of it satisfies the requirements under IRC section 274(d). Therefore, the Tax Commission upholds the Bureau's adjustments regarding these expenses.

Other expenses⁶

As for the other expenses where the Cohan rule may be applicable, Appeals requested the representative provide a reasonable estimate for the Tax Commission's consideration, but he did not. There is no record establishing the possibility of approximating an expense amount nor a method for doing so. Therefore, the Tax Commission upholds the Bureau's adjustments as Petitioners did not meet the burden of proving that they are entitled to the deductions claimed.

⁶ i.e. advertising, depreciation, interest, office expense, supplies, taxes and licenses, utilities, and other expenses (conference expenses, webservices, digital printing, education, credit card fees, and telephone).

■

Travel, entertainment, gifts, and listed property expenses

Mr. ■ was appointed to the board of ■ (■) ⁷ on May 27, 2021. The representative explained that Mr. ■, as a board member, was required to travel to the states where the board meetings were held. For tax years 2021 and 2022, Mr. ■ received a Form 1099 for his compensation as a board member. ■ changed its name to ■ in December 2022. For tax year 2023, Mr. ■ received a Form W-2 based on his employment agreement with ■ a subsidiary of ■. Appeals requested the representative provide Mr. ■'s travel logs, the minutes for the board meetings, and a copy of his initial employment agreement. Appeals did not receive the requested information. Instead, the representative requested the Tax Commission make a final decision based on the documentation and information previously provided. ⁸ The expenses incurred for travel, meals, and entertainment expenses are subject to strict substantiation requirements under IRC section 274(d). The Tax Commission reviewed the information provided by the representative and found that none of it meets the requirements under IRC section 274(d). Therefore, the Tax Commission upholds the Bureau's adjustments regarding these expenses.

⁷ ■ had its initial public offering (IPO) on ■ 2022 Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) provides details of the employment agreement. ■ filed its own Form 10-K for 2023, which describes Mr. ■ as the President and Chief Executive Offer, and his employment agreement was amended on February 2, 2024.

⁸ The Tax Commission did not receive the travel logs and the board meeting minutes.

*Other expenses*⁹

The representative explained in the protest that Mr. [REDACTED] was also required to provide his own office supplies, phone and internet to fulfill his position as a board member. However, Mr. [REDACTED] employment agreement, effective [REDACTED] with [REDACTED] states in its “reimbursement of expenses” section that,

During the period Executive is employed hereunder, the Company shall reimburse Executive for reasonable and necessary out-of-pocket expenses advanced or expended by Executive or incurred by him for or on behalf of the Company in connection with his duties hereunder in accordance with its customary policies and practices; provided, however, that Executive shall not expend or incur any such monthly expenses, individually or in the aggregate, in excess of One Thousand Five Hundred Dollars (\$1,500.00) without the approval of the Company.

Appeals requested the representative clarify whether the terms for expense reimbursement were the same for all years under review, but the representative did not provide it. Appeals also requested the representative clarify whether the business expenses Mr. [REDACTED] claimed on his Schedule C for [REDACTED] include his personal expenses. The representative responded, stating that they were legitimate business expenses, but provided no explanation or business reason. Therefore, the Tax Commission upholds the Bureau’s adjustments as Petitioners did not meet the burden of proof that they are entitled to the deductions reported.

The Bureau’s adjustments to Petitioners’ Schedule Cs changes Petitioners’ net business income, which also changes Petitioners’ deductions for QBI and self-employment tax. However, the Bureau did not adjust Petitioners’ QBI and self-employment tax deductions in the Notice.

Idaho Code section 63-3002 states in part,

...the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, subject only to

⁹ i.e. advertising, depreciation, interest, office expense, supplies, taxes and licenses, utilities, and other expenses (conference expenses, webservices, digital printing, education, credit card fees, and telephone).

¹⁰ The employment agreement with [REDACTED], a subsidiary of [REDACTED].

modifications contained in the Idaho law; to achieve this result by the application of the various provisions of the Federal Internal Revenue Code relating to the definition of income,..., resulting in an amount called "taxable income" in the Internal Revenue Code, and then to impose the provisions of this act thereon to derive a sum called "Idaho taxable income";...

Petitioners' Idaho returns start with their federal adjusted gross income, which includes their Schedule C income/loss and adjustments to income.¹¹ Since the Tax Commission upholds the Bureau's Schedule C adjustments, which changes Petitioners' federal adjusted gross income, the Tax Commission will now review these SE tax and QBI deductions.

SE tax

The calculation of self-employed tax generally starts with net business income (gross business receipts minus total allowable business expenses). 92.35% of the net business income is subject to self-employment tax (taxable self-employment income). To calculate the social security tax, the 12.4% social security tax rate would be applied to the taxable self-employment income.¹² The Medicare tax is calculated at 2.9% of the taxable self-employment income. The sum of the social security tax and the Medicare tax is total self-employment tax, and one half of the total self-employment tax is deductible for a taxpayer when calculating federal adjusted gross income.

Because of the Bureau's adjustments to Petitioners' Schedule C expenses, their net business income increased, which also increased their taxable self-employment income. Therefore, Petitioners' deductible amount of self-employment tax should also increase. The Tax Commission modifies the Notice to allow additional self-employment tax.

¹¹ Federal Form 1040, Schedule 1, Part II, Adjustments to Income.

¹² Annual limit is \$142,800 for 2021, \$147,000 for 2022, and \$160,200 for 2023.

QBI deduction

Internal Revenue Code section 199A provides that noncorporate taxpayers may claim an income tax deduction up to twenty percent (20%) on their QBI in tax years 2018 through 2025. Idaho Code section 63-3002 states in part, "... the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in the Idaho law..." QBI includes net business income on Schedule C, and therefore a change in Schedule C income or expenses will change the net business income that is subject to the QBI deduction.

The representative argued that the Bureau should have increased the QBI deduction as Petitioners' net business incomes would increase due to the Bureau's adjustment to their Schedule C expenses. The representative further argued that, since there is no Idaho statute that removes the QBI for Idaho purposes, the QBI deductions should be calculated based on the QBI as adjusted by the Bureau.

The Tax Commission reviewed the Notice and found that Petitioners' taxable income increased because of the Bureau's adjustments to Petitioner's Schedule C expenses. As a result, Petitioners' QBI also increased. On their 2021 return, Petitioners reported a qualified business loss carryover from prior years. Because of the increase in their QBI, the qualified business loss from prior years would be fully absorbed, which would result in a taxable income after application of qualified business net loss from prior years and before QBI deduction. Therefore, Petitioners are entitled to a deduction for their QBI at an applicable percentage. Idaho returns start with the federal adjusted gross income before the QBI deduction, and the allowable QBI deduction needs to be subtracted from total Idaho adjusted income in arriving at Idaho taxable income. Therefore, the Tax Commission modifies the Notice to allow the QBI deduction.

Negligence penalty

Idaho Code section 63-3046(a) states,

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.

Tax Administration and Enforcement Rule IDAPA 35.02.01.410.02., further clarifies that,

[a] five percent (5%) negligence penalty shall be imposed if the deficiency results from either negligence by the taxpayer or from disregard by the taxpayer or his agent of state or federal tax laws, rules of the Tax Commission, or Treasury Regulations.

The negligence penalty, or so-called accuracy-related penalty, applies to negligence or disregard of the rules or regulations. Negligence is when a taxpayer does not make a reasonable attempt to follow the tax laws, and disregard means a taxpayer carelessly, recklessly or intentionally ignored tax rules or regulation.

The representative argued in the protest that the Bureau improperly disallowed the Schedule C expenses and therefore there is no justification for the penalty. The representative argued that Petitioners provided all the information requested by the Bureau and was willing to provide any information if the Bureau requested.

Idaho Code section 63-3046 (7) states,

The state tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that **there was reasonable cause** for the understatement (or part thereof) and that the taxpayer **acted in good faith**. (emphasis added)

The Tax Commission agrees that Petitioners acted in good faith as they took the time and effort to hire an accountant with expectations that the accountant would prepare a complete and accurate return. As for the reasonable cause standard under IRC section 6664 and its Treasury Regulation, the Tax Commission now reviews the “three-prong test.”

In *Neonatology v. Commissioner*, 115 TC 43 (2000), the Tax Court relied on the “three-prong test” in determining whether a negligence penalty is applicable:

In sum, for a taxpayer to rely reasonably upon advice so as possibly to negate a section 6662(a) accuracy-related penalty determined by the Commissioner, the taxpayer must prove by a preponderance of the evidence that the taxpayer meets each requirement of the following three-prong test:

- (1) The adviser was a competent professional who had sufficient expertise to justify reliance,
- (2) The taxpayer provided necessary and accurate information to the adviser, and
- (3) The taxpayer actually relied in good faith on the adviser's judgment.

Petitioners prepared their Idaho returns for tax year 2021, but their 2022 and 2023 returns were prepared by [REDACTED] an accounting firm in [REDACTED], Idaho. Although their 2021 return was self-prepared, Petitioners relied on a tax professional for tax years 2022 and 2023; therefore, they met the first test only for tax years 2022 and 2023. Petitioners apparently provided their accountant with all information they had for preparation of their returns. Petitioners meet the second test. As for the third test, Petitioners filed their 2022 and 2023 returns as prepared by their accountant. Since they relied in good faith on the accountant, they meet the third test. The Tax Commission found that Petitioners exercised ordinary business care and prudence in determining the tax liability by engaging the accounting firm to prepare their 2022 and 2023 returns. The Tax Commission determined that Petitioners met the reasonable cause standard and therefore the negligence penalty should be abated for tax years 2022 and 2023, but not for tax year 2021.

Interest

Idaho Code section 63-3045(7)(b) states in part,

Interest upon any deficiency shall be assessed at the same time as the deficiency, shall be due and payable upon notice and demand from the state tax commission and shall be collected as a part of the tax

The Idaho Supreme Court's decision in *Potlatch Corp. v. Idaho State Tax Comm'n*, 128 Idaho 387, 913 P.2d 1157 (1996) established that interest may be imposed as written in the Idaho statute, and that the Tax Commission is authorized to add interest to any tax deficiency in accordance with Idaho Code section 63-3045. The Tax Commission's decisions routinely affirm the addition of interest to deficiencies.

Petitioners referred to Idaho Code section 63-3046 and stated in the protest that "the Tax Commission has authority to waive penalties and interest when reasonable cause is demonstrated." As mentioned previously, the Tax Commission does have the authority to waive penalties as provided by Idaho Code section 63-3046.¹³ However, interest is defined under Idaho Code section 63-3045, and none of its subsections allow for abatement of interest. As the court held in the Potlatch case, the Tax Commission found that the Bureau's addition of interest is appropriate.

CONCLUSION

The Tax Commission found no business reason for the expenses Petitioners deducted on their Schedule Cs and therefore upholds the Bureau's adjustments. The Bureau's adjustments to Petitioners' Schedule C expenses changed their net business income, which also changed their deductible amount of self-employment tax and QBI. Therefore, the Tax Commission modifies the Notice to increase the amount of deduction for self-employment tax and QBI.

The Tax Commission abates the 5% negligence penalty for tax years 2022 and 2023 but not for tax year 2021. The Bureau added interest to the tax due amounts for each year, and the Tax

¹³ Idaho Code section 63-3046 (7) states, "The state tax commission may waive all or any part of the addition to tax provided **by this section** on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith." (emphasis added) The part "by this section" means Idaho Code section 63-3046.

Commission finds this addition appropriate and in accordance with Idaho Code sections 63-3045 and 63-3046.

THEREFORE, the Tax Commission MODIFIES the Notice dated February 21, 2025, directed to Petitioners.

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>
2021	\$7,329	\$366	\$898	\$8,593
2022	4,419	0	382	4,801
2023	2,618	0	88	2,706
			TOTAL DUE	<u>\$16,100</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 _____ 2026.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2026,
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:

Receipt No.

[REDACTED]

[REDACTED]

[REDACTED]