

LAW AND ANALYSIS

During the hearing, the representative explained the flow-through adjustments are the root cause for the penalties and argued that the Tax Commission should waive both substantial understatement and negligence penalties because there was reasonable cause for the understatement and Petitioner acted in good faith.

The substantial understatement penalty is set forth in Idaho Code section 63-3046(d).

- (1) 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.
- (2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
 - (i) Ten percent (10%) of the tax required to be shown on the return for the taxable year, or
 - (ii) Five thousand dollars (\$5,000).
- (4) For purposes of paragraph (d)(2) of this section, the term "understatement" means the excess of:
 - (i) The amount of tax required to be shown on the return for the taxable year, over
 - (ii) The amount of the tax imposed which is shown on the return.

The computation of the amount of the understatement of tax and the determination that it is substantial are mechanical processes under subsections (2) and (4) of the quoted subsection. In the present case, the substantial understatement of the gain from the sales of partnership interest and stock in an S-Corp resulted in the tax deficiency, which exceeded the threshold provided in Idaho Code section 63-3046(d)(2)(i) and (ii).

As for the 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 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.

And provides an example of situations that justify the negligence penalty as,

e. Unreported taxable income is a material amount as compared with the reported income.

Idaho Code section 63-3046(d)(7) is applicable not just to the substantial understatement penalty but also to the negligence penalty, states:

[t]he 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.

Petitioner included the gains in its federal return but inadvertently did not source the gains to Idaho in its nonresident return. The representative believes that there was reasonable cause for the deficiency and argued that the Idaho statute regarding the sourcing of gains from sales of partnership interest and stock in an S-Corp is somewhat unique to Idaho. The representative argued that, while many states apportion a shareholder's gain from sales of partnership interest and stock in an S-Corp to the shareholder's state of residence, Idaho does not. The representative believes that the uniqueness in the Idaho statute caused the exclusion of gain in calculation of Petitioner's Idaho source income. The representative also argued that Petitioner exercised ordinary business care and prudence in determining the tax liability by engaging the representative² to prepare its 2020 return. Petitioner provided the representative with all relevant tax information with the expectation that the representative would prepare a complete and accurate return. Petitioner reasonably and in good faith relied on the representative for the ordinary tax treatment of the Idaho

² [REDACTED]

income tax law; therefore, the representative believes that Petitioner met the reasonable cause standard under Internal Revenue Code section 6664 and its Treasury Regulation³.

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.

After careful consideration, the Tax Commission finds that there was reasonable cause for the understatement (or part thereof) and that Petitioner acted in good faith.

CONCLUSION

The Tax Commission abates the 5% negligence penalty and the 10% understatement penalty. The Notice added interest to the tax due amount, and the Tax Commission finds the addition appropriate; however, in accordance with Idaho Code section 63-3045(b), the Tax Commission must issue a refund of interest as it stops accruing as of December 31, 2023. The Tax Commission applies the payments received from Petitioner to this decision.

THEREFORE, the Tax Commission MODIFIES the Notice dated December 13, 2023, directed to Petitioner.

³ Treasury Regulation section 1.6664-4(c).

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2020	\$8,259	\$0	\$765	\$9,024
			Less: Payment Received	(9,094)
			Total Refund	<u>\$(70)</u>

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

DATED this _____ day of _____ 2025.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2025,
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]