

In the Matter of the Protest of

DECISION

██████████ (Petitioners) protested the Notice of Deficiency Determination (Notice) for tax years 2018 through 2022 dated March 13, 2024. This protest carried forward to modified Notices dated July 19, 2024, and August 9, 2024. The Tax Commission reviewed the matter and hereby issues its final decision to further modify the Notice.

Petitioners filed joint income tax returns for tax years 2018 through 2022 (audit period). For 2022, they filed as nonresidents of Idaho; for all other years during the audit period, they filed as Idaho residents. The Tax Commission's Tax Discovery Bureau (Bureau) selected these returns for examination and sent letters requesting information and documentation regarding activities reported on federal Schedule C and dependents claimed on their returns. The Bureau did not receive any documentation and issued the original Notice on March 13, 2024. The Notice increased Petitioners' Idaho taxable income for the audit period by including previously unreported income for 2018 through 2020 and disallowing all deductions for expenses claimed on federal Schedule C for the audit period. Additionally, the Bureau determined that Petitioners were Idaho residents for 2022 and adjusted their Idaho taxable income accordingly.

On April 24, 2024, Petitioners' attorney-in-fact (AIF) sent a letter requesting a redetermination. According to that letter, Petitioners "were not given a chance to work with the tax commission's representative to give requested information." Petitioners were under the

impression that the Bureau was in contact with and working with AIF, but there was an error on the Power of Attorney (POA) form naming him as their representative which prevented that. Due to a miscommunication, Petitioners were unaware of any issue preventing the Bureau from talking with AIF, and the Bureau issued the Notice before Petitioners or AIF knew about the error. AIF provided a corrected POA form with his letter requesting the redetermination. On April 25, 2024, the Bureau sent Petitioners and AIF a letter acknowledging the protest and requesting the same documentation and information as in the two letters sent prior to the Notice.

In June 2024, the Bureau spoke with AIF regarding an administrative error with the adjustments for tax year 2020. The amount of Schedule C expenses disallowed was inadvertently also reported as income Petitioners had not included on their return. The Bureau issued a modified Notice dated July 19, 2024, to correct this.

On August 5, 2024, the Bureau received documentation of business expenses for 2020, 2021, and 2022 from AIF. Using the information from the receipts, the Bureau issued a new modified report dated August 9, 2024, reducing the disallowed portion of Schedule C business expenses for these three years. The Bureau did not change the adjustments for 2018 or 2019.

On September 6, 2024, AIF provided a statement with some additional documents. He wrote that they (he and Petitioners) still disagreed with the modified Notice and explained his reasons:

- 2018- No disagreement as Petitioners were unable to locate any information.
- 2019- Most records were gone, but what they could find regarding professional fees of \$35,000 was attached.
- 2020- Providing additional information regarding professional fees of \$30,000.
- 2021- Agree with the changes.
- 2022- Okay with changes made to expenses but disagreed that Mrs. [REDACTED] was an Idaho resident.

The documentation of professional fees for 2019 consisted of two bank statements showing “Transfer to [REDACTED] per [REDACTED] and “Transfer to [REDACTED] [REDACTED] per [REDACTED] totaling \$35,000 during 2019. Additionally, AIF provided copies of a credit slip and a debit slip dated March 12, 2020, both for \$15,000. AIF also requested clarification of what business expenses had been allowed for 2020 through 2022.

The Bureau replied to AIF, requesting documentation to show that Mrs. [REDACTED] had changed her domicile from Idaho and was a nonresident for 2022, as well as additional information to show the business purpose for the professional fees being claimed. On September 20, 2024, AIF uploaded a copy of Mrs. [REDACTED] Nevada driver’s license and a lease agreement for a Nevada property (covering September 1, 2021, through December 31, 2023) to show she was not an Idaho resident in 2022. AIF did not provide any additional information about the professional fees. The Bureau determined that Mrs. [REDACTED] was not an Idaho resident and sent AIF an email stating that the adjustments for 2022 had been removed from the examination.

Petitioners and AIF did not withdraw the protest, so the Bureau forwarded the matter to the Tax Commission’s Tax Appeals unit (Appeals). On November 6, 2024, Appeals sent letters to Petitioners and AIF explaining the options available for redetermining a protested Notice. Appeals included with this letter a breakdown of the expenses the Bureau allowed which resulted in the final modified Notice. AIF responded via email on November 22, 2024. In his cover letter, he wrote, “In reviewing the information of the allowed business expenses, I feel comfortable with what the commission has allowed. The exception to that is the legal fees.” He stated that Petitioners were able to obtain actual invoices for the legal fees and attached copies. These invoices dated

during 2019 and 2020 were for legal services from [REDACTED] [REDACTED]¹. He continued, “We believe these legal fees are directly related to the production of income for the taxpayer.” Some of Petitioners’ clients were contacted directly during Mr. [REDACTED] investigation, which AIF wrote affected ongoing business interests and relationships with the clients.

Appeals and AIF exchanged additional emails over the next two months, during which AIF provided additional receipts for legal services and Appeals requested clarification showing the connection these payments had to Petitioners’ Schedule C activities. In an email sent to Appeals on December 20, 2024, AIF wrote:

On the March 1, 2020 statement items dated 02/13/2020 there shows a charge for restitution in the amount of \$47,735.72. This is the same amount to the dollar of the amount of unreported income that Idaho is claiming for tax years 2018 and 2019. I believe since this money was repaid that it should not be counted as unreported income for those years. In the worst case it should be an offset to income reported in the year it was repaid in 2020.

AIF and Appeals continued discussion of the issues via email but were unable to agree on the matter. At no time during the redetermination process did AIF or Petitioners request an informal hearing. As the protest of the Notice has not been withdrawn, the Tax Commission must render its decision based on the information currently available.

Law & Analysis

The Bureau’s Notice and modified Notices cover the audit period from 2018 through 2022. While the Bureau indicated to AIF that tax year 2022 had been removed from the examination based on documentation showing that Mrs. [REDACTED] was a nonresident of Idaho in 2022, the year remains on the latest Notice that was issued. After reviewing the documents provided, the Tax

¹ Between 2019 and 2020, Mr. [REDACTED] was under investigation and on trial for multiple criminal charges. In 2020, he plead guilty to two charges. The one relevant to this case is Grand Theft by Deception under Idaho Code section 18-2403(2)(a). [REDACTED] [REDACTED] was Mr. [REDACTED] defense attorney.

Commission agrees with the Bureau's determination and has accepted Petitioners' 2022 income tax return as filed. There will be no further mention of tax year 2022 in this decision.

IRC section 162(a) allows taxpayers to claim deductions for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any business or trade." To qualify as a deduction, an item must be not only an expense, but an ordinary and necessary one, and it must be incurred or paid during the tax year for which it is claimed, as well as being incurred or paid in the conduct of a trade or business. An ordinary expense is one that is customary or usual within a certain trade or business.² A necessary expense is one that is appropriate and helpful in the development of the business.³

AIF expressed in his emails that he agreed with the Bureau's adjustments to deductions for business expenses on Schedule C except for legal fees. The Bureau received information showing that Mr. [REDACTED] was arrested in June 2019 and charged with multiple crimes. His defense attorney throughout the proceedings was [REDACTED] [REDACTED]

As evidence of the 2019 legal fees, AIF provided the Bureau with D. L. Evans bank statements showing two payments totaling \$35,000 transferred to [REDACTED] [REDACTED] in 2019. The Tax Commission does not dispute that Petitioners paid at least \$35,000 in legal fees to [REDACTED] [REDACTED] during 2019.

As evidence of the 2020 legal fees, AIF provided the Bureau with two transaction slips showing \$15,000 each. AIF stated this showed \$30,000 in payment of legal fees. The Tax Commission disagrees with this total for the following reasons:

- One is a debit voucher. The other is a credit voucher. This indicates a withdrawal and a deposit.

² *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940)

³ *Commissioner v. Heining*, 320 U.S. 467, 471 (1943)

- Both vouchers are dated March 12, 2020, and prepared by the same teller, indicating they were likely from the same transaction.
- The debit voucher is signed by Mrs. [REDACTED] and the account number matches the information on the 2019 bank statements in her name (account ending in 0316). A signature would be required for a withdrawal of \$15,000.
- The credit voucher is not signed, and the account number does not match any information linked to Mrs. [REDACTED]
- There is a history of direct transfers at D. L. Evans bank between Mrs. [REDACTED] and Mr. [REDACTED]
- The statement from [REDACTED] [REDACTED] dated March 31, 2020, shows a retainer payment of \$15,000 on March 12, 2020.

Based on this information, the Tax Commission determined that the two vouchers represent a single payment of \$15,000 to [REDACTED] [REDACTED] for legal services. The bank statements and vouchers provided to the Bureau are evidence of payment, but they contain no indication of a business purpose.

The IRS and Courts have a history of allowing deductions for legal fees incurred by an individual in defense against criminal charges arising from his business activities. However, those fees are not deductible if they are personal expenses of the taxpayer. AIF provided statements from [REDACTED] [REDACTED] showing dates of service, the description of service, the number of hours charged, and the fees incurred. AIF highlighted seven entries in 2019 and nine entries in 2020 that he said were for activities “directly related to the production of income for the taxpayer.” The activities include editing and revising documents; reading and sending emails; reviewing records, photos, and reports; conducting conferences and phone calls with his client and others; and preparing letters.

In his letter to the Bureau in November 2024, AIF claimed that legal fees were business related because some of Petitioners’ clients had been contacted as part of the criminal investigation. Several of the highlighted activities from the statements show names other than Petitioners and law enforcement officials. However, there is no evidence to show that the people

contacted were Petitioners' clients. Nor was there evidence that the activity was directly related to maintaining the business relationship of Petitioners to a client. Without that evidence, the Tax Commission determined that Petitioners and AIF did not meet their burden to show that the expense was ordinary, necessary, and related to the conduct of a trade or business. Rather, the legal fees were incurred in defending Mr. [REDACTED] against criminal charges that arose from his personal activity. Therefore, the Bureau's disallowance of the legal fees must stand.

In a December 20, 2024, email to Appeals AIF stated:

As I was reviewing the bills though one item caught my attention that I had not noticed before. On the March 1, 2020 statement items dated 02/13/2020 there shows a charge for restitution in the amount of \$47,735.72. This is the same amount to the dollar of the amount of unreported income that Idaho is claiming for tax years 2018 and 2019. I believe since this money was repaid that it should not be counted as unreported income for those years. In the worst case it should be an offset to income reported in the year it was repaid in 2020.

After reviewing the documentation available, the Tax Commission concluded that this payment of \$47,735.72 was restitution of the amounts the Bureau included as unreported income for 2018 and 2019 (the amounts for which Mr. [REDACTED] pleaded guilty to grand theft by deception).

A taxpayer must include illegal gains in gross income⁴. In Petitioners' case, Mr. [REDACTED] pleaded guilty to theft by deception. The income that he received related to this charge must be reported, and it must be included on the returns for the years the income was received – 2018 and 2019⁵. There is no offset of gross income in a later year simply because that income is paid back.

However, when a taxpayer properly reports on their return income from illegal activities, they can deduct from their income in the year they pay restitution an amount equal to the restitution

⁴ Treasury Regulation section 1.61-14(a)

⁵ JAMES v. U.S., 7 AFTR 2d 1361 (366 U.S. 213), (S Ct), 05/15/1961; Revenue Ruling 61-185; TC Memo 1964-153; U.S. v. JANNSEN, 15 AFTR 2d 64 (339 F.2d 916), (CA7), 12/30/1964; U.S. v. SIANO, 17 AFTR 2d 458 (356 F.2d 927), (CA2), 02/28/1966.

paid as long as it is not a fine or punishment. The facts in this examination are similar to, but not exactly the same as, those described in *Revenue Ruling 65-254*. In that case, the taxpayer embezzled money from his employer over several years and repaid the total when the embezzlement was discovered. Internal Revenue Code (IRC) section 165(a) allows “as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.” For individuals, these losses are limited to 1) losses incurred in a trade or business; 2) losses incurred in any transaction entered into for profit, though not connected to a trade or business; and 3) certain losses arising from fire, storm, shipwreck or other casualty, or theft. In *Revenue Ruling 65-254*, it was found that each act of embezzlement the taxpayer undertook was a transaction entered into for profit. Therefore, the taxpayer was allowed a deduction under IRC section 165(a) for the repayment of the embezzled funds, but only if the taxpayer did not elect to use the standard deduction.

Similarly, the Tax Commission finds that Petitioners would be allowed to claim an itemized deduction for the restitution paid in 2020, except that miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income floor are not allowed for tax years 2018 through 2025⁶. Only specified expenses are still deductible, and a deduction otherwise allowed under IRC section 165(a) is not allowed unless it is for a casualty or theft loss described in IRC section 165(c)(2) or 165(c)(3) or a loss described in section 165(d). AIF argued that a miscellaneous itemized deduction would still be allowed under IRC section 1341 since the amount repaid was more than \$3,000. However, “[IRC] section 1341 [does] not apply to the restoration of illegally obtained funds.”⁷ Section 1341 applies if all three of these conditions are met:

⁶ Refer to IRC section 67(g)

⁷ TC Memo 1995-409. See also *Yerkie v. Commissioner*, 67 TC 388, 390 (1976); *McKINNEY v. U.S.*, 42 AFTR 2d 78-5227 (574 F.2d 1240), (CA5), 06/13/1978; *HERZOG v. U.S.*, 71A AFTR 2d 93-3204, (DC-MN), 05/24/1989

- An item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an *unrestricted right* to such item. [*emphasis added*]
- A deduction is allowable *for the taxable year* because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item. [*emphasis added*]
- The amount of such deduction exceeds \$3,000.

Petitioners do not qualify for relief under IRC section 1341 for two reasons. First, “[t]he statute's ‘unrestricted right’ language must be read to exclude from its coverage all those who receive earnings knowing themselves to have no legal right thereto.”⁸ In Mr. [REDACTED] case, the income in question was retirement benefits paid in his mother’s name after her death. The Tax Commission finds it implausible that a reasonable person would believe they were entitled to receive the retirement benefits paid in a decedent’s name. Second, a deduction must be otherwise allowable for the year. As previously established, no deduction for the restitution payment is allowable in 2020. Therefore, the Tax Commission determined that Petitioners are not entitled to a reduction of taxable income related to the restitution paid in 2020.

As a result of the disallowed Schedule C business expenses described above, Petitioners’ self-employment income increased. For 2018 and 2019, the Tax Commission determined that Petitioners were allowed additional deduction for one-half of self-employment tax (\$1,142 and \$848, respectively). For 2020 and 2021, the disallowed expenses do not result in positive self-employment income. Therefore, no self-employment tax is due, and no related deduction is allowed.

In addition to self-employment income on Schedule C, Petitioners also reported income from partnerships on Schedule E. The Schedule C and Schedule E incomes and deduction for self-employment tax combine to determine Petitioners’ qualified business income (QBI). Beginning in

⁸ *PEREZ v. U.S.*, 51 AFTR 2d 83-519, Code Sec(s) 1341, (DC-FL), 11/10/1982

2018, Petitioners were eligible to claim a deduction equal to 20% of their QBI. Based on the returns filed and the adjustments made to Schedule C and self-employment tax, the Tax Commission allowed additional QBI deduction (\$11,326 for 2018; \$11,167 for 2019; \$5,043 for 2020; and \$4,665 for 2021).

The Bureau added interest to Petitioner's tax deficiency. The Tax Commission reviewed this addition and finds it to be appropriate and in accordance with Idaho Code section 63-3045. The Bureau also added a 50% fraud penalty to Petitioner's tax deficiency. The Tax Commission reviewed this addition and finds it to be appropriate and in accordance with Idaho Code section 63-3046.

Conclusion

Petitioners' remaining disagreement with the modified Notice dated August 9, 2024, centered around legal fees claimed as business expenses. Petitioners have not met their burden of proof to show that the legal expenses paid were ordinary and necessary in the conduct of the activities reported on Schedule C. The restitution they paid in 2020 is not deductible. Petitioners are allowed additional self-employment tax deduction and qualified business income deduction.

THEREFORE, the modified Notice dated August 9, 2024, and directed to [REDACTED] [REDACTED] [REDACTED]

[REDACTED] [REDACTED] [REDACTED] is hereby FURTHER MODIFIED and MADE FINAL.

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> |
|-------------|------------|----------------|-----------------|-----------------|
| 2018 | \$2,025 | \$1,013 | \$388 | \$3,426 |
| 2019 | 4,654 | 2,327 | 638 | 7,619 |
| 2020 | 1,946 | 973 | 210 | 3,129 |
| 2021 | 945 | 473 | 82 | <u>1,500</u> |
| | | | | <u>\$15,674</u> |

The Tax Commission DEMANDS immediate payment of this amount. Interest is calculated in accordance with Idaho Code section 63-3045.

An explanation of Petitioners' 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]