

07-0365
AUDIT
SIGNED 09-03-2009

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2,

Petitioners,

vs.

AUDITING DIVISION OF THE UTAH
STATE TAX COMMISSION,

Respondent.

INITIAL HEARING ORDER

Appeal No. 07-0365

Account No. #####

Tax Type: Income Tax

Tax Years: 2000-2002

Judge: Phan

Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER 1

For Respondent: RESPONDENT REP 1, Assistant Attorney General
RESPONDENT REP 2, COMPANY A

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Sec. 59-1-502.5, on July 7, 2009. Petitioners (the "Taxpayers") are appealing an audit deficiency of Utah individual income tax for the years 2000 through 2002. Respondent (the "Division") issued the Statutory Notices of Deficiency and Audit Change had been issued on February 20, 2007. The Taxpayers timely appealed the audit. The amounts of the audit deficiencies listed on the statutory notices at issue are as follows:

	Tax	Penalty	Interest	Total as of Notice Date ¹
2000	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
2001	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
2002	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$

¹ Interest continues to accrue on the unpaid balance.

APPLICABLE LAW

Utah imposes income tax on individuals who are residents of the state, in Utah Code Sec. 59-10-104 (2002)² as follows:

...a tax is imposed on the state taxable income, as defined in Section 59-10-112, of every resident individual...

State taxable income is defined in Utah Code Sec. 59-10-112 (2002) as follows:

"State taxable income" in the case of a resident individual means his federal taxable income (as defined by Section 59-10-111) with the modifications, subtractions, and adjustments provided in Section 59-10-114 . . .

Federal taxable income is defined in Utah Code Sec. 59-10-111 (2002) as follows:

"Federal taxable income" means taxable income as currently defined in Section 63, Internal Revenue Code of 1986.

Taxable income is defined in the Internal Revenue Code at 26 U.S.C. 63 as:

Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).

If the Internal Revenue Service makes a change to a Utah resident's federal taxable income the resident must file an amended Utah return in Utah Code Sec. 59-10-539(2002) which provides:

If a change is made in a taxpayer's net income on his or her federal income tax return, either because the taxpayer has filed an amended return or because of an action by the federal government, the taxpayer must notify the commission within 90 days after the final determination of such change. The taxpayer shall file a copy of the amended federal return and an amended state return, which conforms to the changes on the federal return. No notification is required of changes in the taxpayer's federal income tax return, which do not affect state tax liability. (b) The commission may assess any deficiency in state income taxes within three years after such report or amended return was filed. The amount of such assessment of tax shall not exceed the amount of the increase in Utah tax attributable to such federal change or correction. The provisions of this Subsection (b) do not affect the time within which or the amount for which an assessment may

² The Utah Individual Income Tax Act has been revised and provisions renumbered subsequent to the audit period. The Commission cites to and applies the provisions that were in effect during the audit period on substantive legal issues.

otherwise be made. However, if the taxpayer fails to report to the commission the correction specified in this Subsection (b) the assessment may be made any time within six years after the date of said correction.

Interest is assessed pursuant to Utah Code Sec. 59-1-402(5)(2002) as follows:

Interest on any underpayment, deficiency or delinquency of any tax or fee administered by the tax commission shall be computed from the time the original return is due excluding any filing or payment extensions, to the date the payment is received.

The applicable statutes specifically provide that the taxpayer bears the burden of proof in proceedings before the Tax Commission. Utah Code Sec. 59-10-543 provides:

In any proceeding before the commission under this chapter, the burden of proof shall be upon the petitioner. . .

DISCUSSION

In this matter the audit deficiencies were the result of an audit by the Internal Revenue Service of the Taxpayers' 2000 through 2002 federal tax filings by which the IRS increased the Taxpayers federal taxable income. Since Utah law provides that state taxable income is based on federal taxable income, this adjustment affected the Taxpayers' Utah individual income tax liability. There was no dispute from the Taxpayers that the Utah audit deficiency was based on the final federal taxable income as determined by the IRS. The Taxpayers' contention with the audit was that the IRS final determination was incorrect.

During the audit years the Taxpayer PETITIONER had been a member or partner in COMPANY B. The L.L.C. was taxed like a partnership, so income and expenses flowed through to PETITIONER as a 50% partner and (X) as the other 50% partner. When the IRS audited PETITIONER and his partner individually, PETITIONER sought tax advice. He understood from his tax representative at that time that the IRS would first have to audit the L.L.C. and finalize that audit, so that he did not need to file an appeal of the personal audit issued against him by the IRS. In the audit, the IRS reduced the inventory purchase amounts and thus reduced the costs of goods sold as well as reduced deductions claimed for expense overpayments that had been claimed on the L.L.C.'s return, which in turn flowed through to the partners individual returns. PETITIONER did not appeal the audit issued against him personally by the IRS or follow the administrative process through the IRS based on the accountants' advice. PETITIONER states that it turned out the advice he had received from his accountant was incorrect for this type of entity.

The Taxpayer indicates that his partner, however, did file an appeal of the audit issued against him personally to the IRS. His partner's case did eventually get resolved in an IRS Tax Court proceeding in early 2009. As a result of his partner's appeal, the IRS did go back and adjust some of the changes it had originally made to income and deductions of the L.L.C. and then flowed those changes through to the Taxpayers' partner's return. Although he was also a 50% partner, because the Taxpayer had not appealed his personal IRS audit deficiency none of these changes were made to the Taxpayer's federal taxable income. The audit for the Taxpayer stood as originally issued by the IRS.

As of the date of the hearing, the Taxpayer has not filed amended federal returns with the IRS based on the changes made to the L.L.C. income and deductions as he indicated he thought at this point the IRS would not even consider or process the returns. Further the Taxpayer did not provide an amended Utah return that was adjusted for the items that the IRS had determined should have flowed through from the L.L.C. to his return. At the hearing he indicated that his accountant had prepared amended Utah returns that followed the IRS changes made for the L.L.C. and how those changes flowed through to his return, but he felt the amended returns were still incorrect in regards to other income or expenses that had not come from the L.L.C., so he did not submit the returns at the hearing.

It was the Division's position that because the IRS had not made any of the changes to the Taxpayers federal taxable income, the Division's state audit was correct, even if the IRS had made the changes to his partners' return. The Division argued that state taxable income is based on federal taxable income. Since the income in question was based on an IRS audit, the determination of federal taxable income is final and the Division would not consider an independent determination of the correct amount of federal taxable income.

Upon review of the issues in this case, the Commission notes that although it does generally give deference to the IRS in determining federal taxable income, the Commission has found in prior decisions that it would consider making an independent determination regarding a person's federal taxable income, if that person had failed to appeal an audit administratively or otherwise to the IRS, due to failing to meet deadlines or other procedural issues and, if it was clear that the IRS' determination was in error.³ In this case it is clear and undisputed by the Division that the IRS did readjust its audit regarding the income and expenses of the L.L.C. and then flowed those adjustments down to the Taxpayers' partner's return. It is also clear that those same adjustments should be made to the Taxpayers' return.

³ See Tax Commission decisions issued in Appeal Nos. 06-1408, 07-1036, 03-0510 & 03-0586.

However, the Taxpayers have the burden of proof in this matter. They need to show how the IRS changes to the L.L.C. would flow through to their personal returns for the years at issue. The Taxpayers did not provide federal or state amended returns that incorporate the IRS changes in income and deductions, or show how these affected their own returns. If the Taxpayers were to present documentation that substantiated how the changes made by the IRS would flow through to the Taxpayers own return, the Commission may consider making a determination of federal taxable income independently from that done by the IRS.

DECISION AND ORDER

Based upon the information presented at the hearing, the Commission sustains the audit deficiencies for all three-tax years at issue. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2009.

Jane Phan
Administrative Law Judge

Appeal No. 07-0365

BY ORDER OF THE UTAH STATE TAX COMMISSION.

DATED this _____ day of _____, 2009.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

NOTICE: If a Formal Hearing is not requested, failure to pay the balance due as determined by this order within thirty days of the date hereon, may result in a late payment penalty. Petitioner may contact Taxpayer Services at (801) 297-7703 to make payment arrangements.

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