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BEFORE THE UTAH STATE TAX COMMISSION

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PETITIONER 1 & PETITIONER 2,

Petitioners,

v.

AUDITING DIVISION OF THE UTAH STATE  
TAX COMMISSION,

Respondent.

**FINDINGS OF FACT, CONCLUSIONS OF  
LAW AND FINAL DECISION**

Appeal No. 07-0563

Account No. #####

Tax Type: Income Tax

Tax Year: 2003 & 2004

Judge: Phan

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**Presiding:**

D'Arcy Dixon Pignanelli, Commissioner  
Jane Phan, Administrative Law Judge

**Appearances:**

For Petitioner: PETITIONER 1  
For Respondent: RESPONDENT REP 1, Assistant Attorney General  
RESPONDENT REP 2, Income Tax Audit Manager  
RESPONDENT REP 3, Senior Auditor

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on April 2, 2009, pursuant to the provisions of Utah Code Secs. 59-1-501 and 63G-4-204 et al. The matter is before the Commission on Petitioners' appeal of audit deficiencies for the tax years 2003 and 2004. Based upon the evidence and testimony presented at the hearing the Tax Commission hereby makes its:

FINDINGS OF FACT

1. This matter is before the Commission on Petitioners' (the "Taxpayers") appeal of income tax, and interest deficiencies issued against them for tax years 2003 and 2004. The Statutory Notices of Deficiency and Audit Change had been issued on April 11, 2007, and April 12, 2007, respectively. No penalties were assessed with the audit.

2. The amount of the deficiency indicated in the Statutory Notices are as follows:

| Year | Tax        | Interest   | Total <sup>1</sup> |
|------|------------|------------|--------------------|
| 2003 | \$\$\$\$\$ | \$\$\$\$\$ | \$\$\$\$\$         |
| 2004 | \$\$\$\$\$ | \$\$\$\$\$ | \$\$\$\$\$         |

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<sup>1</sup> Interest as calculated to the date of the Statutory Notices. Interest continues to accrue on the unpaid balance.

3. The Taxpayers had filed Utah Resident Individual Income Tax Returns as well as Federal Income Tax returns for each of the years at issue. The Internal Revenue Service had made some changes, which increased the Taxpayers' federal taxable income. The Division's audit deficiency is based on the increase in federal taxable income as determined by the IRS.

4. At issue in this matter was partnership income reported on K-1's from two different entities. The first, COMPANY A ("COMPANY A"), was a payroll company, which in 2003 reported ordinary income in the amount of \$266,396 on its Form 1065. COMPANY A had several partners and issued K-1's on the percentage of the partners ownership interests. COMPANY A issued to the Taxpayers individually a K-1 for \$\$\$\$\$, which represented their individual ownership interest of 5%. In addition to other partners, COMPANY A issued to COMPANY B Trust ("COMPANY B") a K-1 in the amount of \$\$\$\$\$, for its 35% ownership interest in COMPANY A.

5. The Taxpayers were the beneficiaries of COMPANY B. COMPANY B issued a K-1 to the Taxpayers in the amount of \$\$\$\$\$. At the hearing the Taxpayer testified that this was the COMPANY A K-1 income after ordinary business deductions. However, the information submitted at the hearing indicates that COMPANY B had other taxable income.

6. The Taxpayers reported on their 2003 federal tax return, in addition to wages and other income, the K-1 for \$\$\$\$\$ issued to them directly from COMPANY A and the K-1 for \$\$\$\$\$ issued to them from COMPANY B, an amount totaling \$\$\$\$\$.

7. COMPANY B's return however, was more complicated than just reporting the K-1 income from COMPANY A. COMPANY B reported a Schedule C ordinary business income of \$\$\$\$\$ for the 2003 tax year<sup>2</sup> and Schedule E Rental Income of \$\$\$\$\$.<sup>3</sup>

8. The IRS eventually audited the Taxpayers' returns and determined the COMPANY B arrangement was a sham with no economic substance. Based on this it was the IRS's determination that the Taxpayers were responsible for the taxable income from the COMPANY B. The IRS recalculated COMPANY B's federal taxable income and then recalculated the Taxpayers' federal taxable income for both 2003 and 2004.

9. For 2003, the IRS increased the Taxpayers' original taxable income of \$\$\$\$\$, by an amount of \$\$\$\$\$ for the income attributed from COMPANY B. The IRS then backed out the \$\$\$\$\$ that the Taxpayers had already claimed on their return from the COMPANY B K-1. There were a couple smaller adjustments and the result was a \$\$\$\$\$ increase by the IRS in taxable income, for a total of \$\$\$\$\$ (the original \$\$\$\$\$ taxable income plus the \$\$\$\$\$ IRS increase).<sup>4</sup>

10. For 2004, the IRS increased the Taxpayers' original taxable income of \$\$\$\$\$, by an amount of

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<sup>2</sup> Petitioner's Exhibit 1, pg. 0119.

<sup>3</sup> Petitioner's Exhibit 1, pg 0125

\$\$\$\$\$ for the COMPANY B income, then backed out the \$\$\$\$\$ that the Taxpayers had already claimed from the COMPANY B K-1 for that year. Again there were some small adjustments and the result was a \$\$\$\$\$ increase by the IRS in taxable income, for a total of \$\$\$\$\$ (the original \$\$\$\$\$ taxable income plus the \$\$\$\$\$ IRS increase).<sup>5</sup>

11. The IRS notices of deficiency were mailed in March and April 2006. The Taxpayers did not timely file a petition for review with the IRS. After the appeal period had expired, the Taxpayers made an attempt to get the matter before the United States Tax Court, but their appeal was dismissed for lack of jurisdiction on November 18, 2008.<sup>6</sup>

12. It was the Taxpayers' position that the IRS had made a mathematical error in computing the income and they asked the Commission to correct the error. The Taxpayer argued that when the IRS determined that COMPANY B should be disregarded, the IRS made errors in increasing his taxable income by \$\$\$\$\$ for the 2003 year. He argued the increase should only have been \$\$\$\$\$, which was 40% (5% from the K-1 issued to the Taxpayers directly and 35% for the K-1 issued to COMPANY B) of COMPANY A's taxable income. Then he argued this amount should have been reduced by \$\$\$\$\$ (the \$\$\$\$\$ he had already claimed from the COMPANY B K-1 and the \$\$\$\$\$ he had claimed from the COMPANY A K-1 issued to him individually.

13. However, a review of the IRS's action does not support the Taxpayers' contention that this was a mere mathematical error, and in fact, the IRS did not calculate the increase in income in the manner explained by the Taxpayer. From the IRS record that the Taxpayers provided, it appears that the IRS' increase for the 2003 tax year of \$\$\$\$\$ was the result of the IRS increasing the amount that COMPANY B had claimed as business income and Schedule E rental income. For the 2003 tax year, the IRS increased the business income from \$\$\$\$\$ to \$\$\$\$\$<sup>7</sup> and increased the Schedule E income from \$\$\$\$\$ to \$\$\$\$\$.<sup>8</sup> It is the IRS' adjusted Schedule E income that equals the amount of COMPANY A's K-1 to COMPANY B. The corrected business and rental income total the \$\$\$\$\$ of income to COMPANY B which the IRS had added to the Taxpayers' individual income. This makes it clear that the IRS had not made a mathematical error in determining the amount of the COMPANY B income. Instead it shows that the IRS specifically concluded that COMPANY B had an additional \$\$\$\$\$ in business income for 2003 in addition to the income reported on the COMPANY A K-1.<sup>9</sup> Additionally, it appears that the IRS only changed the income related to COMPANY B and the K-1 issued directly to COMPANY B. Therefore, it would be inappropriate to subtract out of the \$\$\$\$\$ the \$\$\$\$\$ the taxpayers had claimed on the K-1 distribution from COMPANY A to them personally.

14. The changes for the 2004-year were similar. The IRS increased the COMPANY B income to

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4 Petitioner's Exhibit 1, pg. 0028.

5 Petitioner's Exhibit 1, pg. 0028.

6 Respondent's Exhibit 6.

7 Petitioner's Exhibit 1, pg. 0119.

8 Petitioner's Exhibit 1, pg. 0125.

\$\$\$\$\$ in business income and \$\$\$\$\$ in Schedule E income,<sup>10</sup> for a total of \$\$\$\$\$. Again, this does not appear to be due to the IRS incorrectly calculating the amount attributable from the COMPANY A K-1, but instead due to the fact that the IRS determined there was business income in addition to the amount COMPANY B had claimed on its return for that year.

15. Based on the evidence submitted at the hearing, the increase in federal taxable income was not due to a math error on the part of the IRS. There was no evidence submitted by Petitioners to show that the IRS was incorrect in reaching its conclusions regarding the increase in business income that the IRS attributed to COMPANY B in addition to the Schedule E income related to COMPANY A's K-1. Further, the Taxpayers gave no evidence that would support the conclusion that the IRS erred in finding COMPANY B had been a sham, as the Taxpayer testified at the hearing that he had never met some of the trustees and was not even sure if they were real people. Additionally, the witness for the Division testified that the individual who had advised the Taxpayers in setting up the trust had been charged and convicted of federal tax evasion related crimes.

#### APPLICABLE LAW

Utah imposes income tax on individuals who are residents of the state, in Utah Code Sec. 59-10-104 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 Ann. §59-10-112 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 Ann. §59-10-111 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 USC 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).

The Utah Legislature has specifically provided that the taxpayer bears the burden of proof in proceedings before the Tax Commission. Utah Code Sec. 59-10-543 provides the following:

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

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9 Petitioner's Exhibit 1, pg. 0119.

10 Petitioners Exhibit 1, pgs. 0028, 0119 and 0125.

CONCLUSION OF LAW

Although the Commission agrees with the Taxpayers that the Commission does have authority to determine for purposes of the state tax liability a different federal taxable income from that determined by the IRS, the Commission sustains the audit in this matter. The Commission generally would give deference to an IRS determination of federal taxable income and the Taxpayers have the burden of proof pursuant to Utah Code Sec. 59-10-543 to show the audit assessment was in error. In this case the Taxpayers did not show that the audit was in error.

DECISION AND ORDER

Based on the foregoing, the Tax Commission sustains the audit of additional income tax and interest at issue in this matter for tax years 2003 and 2004. It is so ordered.

DATED this \_\_\_\_ day of \_\_\_\_\_, 2009.

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Jane Phan  
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this \_\_\_\_ day of \_\_\_\_\_, 2009.

Pam Hendrickson  
Commission Chair

R. Bruce Johnson  
Commissioner

Marc B. Johnson  
Commissioner

D’Arcy Dixon Pignanelli  
Commissioner

**Notice:** Failure to pay within thirty days the balance that results from this order may result in additional penalties and interest. You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Sec. 63G-4-302. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Sec. 59-1-601 et seq. & 63G-4-401 et seq.