

07-1036  
INCOME  
TAX YEAR: 2003  
SIGNED: 07-17-2008  
COMMISSIONERS: P. HENDRICKSON, M. JOHNSON  
EXCUSED: D. DIXON  
COMCURRENCE: R. JOHNSON  
GUIDING DECISION

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BEFORE THE UTAH STATE TAX COMMISSION

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PETITIONER,  Petitioner,  v.  AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,  Respondent.	<b>INITIAL HEARING ORDER</b>  Appeal No.    07-1036  Account No.   ##### Tax Type:    Income Tax Year:     2003  Judge:        Chapman
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**Presiding:**  
    Kerry R. Chapman, Administrative Law Judge

**Appearances:**  
    For Petitioner:    PETITIONER REP., Representative  
    For Respondent:    RESPONDENT REP. 1, Assistant Attorney General  
                            RESPONDENT REP. 2, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on July 7, 2008.

PETITIONER (the “taxpayer”) is appealing Auditing Division’s (the “Division”) assessment of individual income tax for the 2003 tax year. On July 19, 2007, the Division issued a Notice of Deficiency and Audit Change (“Statutory Notice”) to the taxpayer, in which it imposed additional tax and interest, as follows:

<u>Year</u>	<u>Tax</u>	<u>Penalties</u>	<u>Interest</u>	<u>Total</u>
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2003                                \$\$\$\$                                \$\$\$\$                                \$\$\$\$                                \$\$\$\$

In its Statutory Notice, the Division informed the taxpayer that the assessment was due to the Internal Revenue Service (“IRS”) disallowing itemized deductions that were taken on the federal return. The disallowed deductions increased the taxpayer’s federal adjusted gross income (“FAGI”), which resulted in the Division issuing its assessment.

APPLICABLE LAW

State Taxable Income. Utah Code Ann. §59-10-112 defines “state taxable income” to mean “federal taxable income (as defined by Section 59-10-111) with the modifications, subtractions, and adjustments provided in §59-10-114.”

UCA §59-10-111 defines “federal taxable income” to mean “taxable income as currently defined in Section 63, Internal Revenue Code of 1986.”

Deficiency. For purposes of Utah’s Individual Income Tax Act, a “deficiency” is defined in UCA §59-10-523(1), as follow:

the amount by which the tax imposed by this chapter exceeds the excess of (a) the sum of (i) the amount shown as the tax by the taxpayer upon his return, if the return was made by the taxpayer and if an amount was shown as the tax by the taxpayer thereon, plus (ii) the amounts previously assessed (or collected without assessment) as a deficiency over (b) the amounts previously abated, refunded, or otherwise repaid in respect of such tax.

UCA §59-10-524(1) provides that “[i]f the commission determines that there is a deficiency in respect of the tax imposed by this chapter, it shall send notice of the deficiency to the taxpayer at the taxpayer's last-known address.”

Burden of Proof. UCA §59-10-543 provides that the burden of proof is upon the petitioner in income tax matters before the Commission, with limited exceptions as follows:

In any proceeding before the commission under this chapter, the burden of proof shall be upon the petitioner except for the following issues, as to which the burden of proof shall be upon the commission:

- (1) whether the petitioner has been guilty of fraud with intent to evade tax;

- (2) whether the petitioner is liable as the transferee of property of a taxpayer, but not to show that the taxpayer was liable for the tax; and
- (3) whether the petitioner is liable for any increase in a deficiency where such increase is asserted initially after a notice of deficiency was mailed and a petition under Title 59, Chapter 1, Part 5 is filed, unless such increase in deficiency is the result of a change or correction of federal taxable income required to be reported, and of which change or correction the commission had no notice at the time it mailed the notice of deficiency.

### DISCUSSION

Although the taxpayer admits that a portion of the Division's assessment is correct, she asks the Commission to reduce the assessment for two reasons. First, the taxpayer contends that the deduction the IRS disallowed was a \$\$\$\$ legal expense that the IRS erroneously reduced to \$\$\$\$\$. The taxpayer contends that the correct amount of the deduction is \$\$\$\$ and proffers evidence from her attorney to support this amount. As a result, the taxpayer requests that her 2003 FAGI be adjusted for state tax purposes to reflect the \$\$\$\$ deduction. Second, the taxpayer proffers evidence to show that a \$\$\$\$ credit for taxes paid to STATE 1 was erroneously omitted from her 2003 Utah tax return. She asks that the \$\$\$\$ amount she overpaid be applied as a credit to reduce the Division's deficiency assessment.

\$\$\$\$ Deduction for Legal Expenses. The IRS disallowed a \$\$\$\$ deduction for legal expenses that the taxpayer took on her 2003 federal return. This action increased the amount of the taxpayer's FAGI for the 2003 tax year. Pursuant to Sections 59-10-111 and 59-10-112, the increase in FAGI at the federal level has a similar effect on the taxpayer's Utah taxable income. For these reasons, the Division asks the Commission not to adjust the taxpayer's 2003 FAGI for purposes of determining state taxable income.

The taxpayer, however, contends that the IRS's action to eliminate the entire deduction is incorrect and that the IRS will not review and determine the proper amount of the deduction. First, the period during which the taxpayer could submit an amended federal return to "correct" the amount of the deduction has expired. Second, the taxpayer states that the IRS refuses to reconsider its actions because it resulted in the taxpayer being subject to the Alternative Minimal Tax ("ATM") and receiving a refund.

In several prior cases, the Commission has used an FAGI amount that is different from the one established by the IRS to determine a taxpayer's state taxable income.<sup>1</sup> However, the Commission has only done so where the IRS will not consider an issue that affects FAGI and where the taxpayer provides proof that FAGI, as reported by the IRS, is incorrect. Given the testimony and evidence proffered at the Initial Hearing, the Commission declines to change the taxpayer's 2003 FAGI for Utah tax purposes.

The Commission is not convinced that the IRS has not already considered and issued a decision on the legal expense deduction issue. First, the taxpayer suggests that the IRS did not reach a determination concerning the deduction because it applied the AMT, which is not impacted by such a deduction. However, the taxpayer also claims that application of the AMT resulted in a refund, which suggests that the amount of tax due under the AMT system is less than the tax due under the "regular" IRS tax system. Without more convincing evidence or testimony to show otherwise, it appears that the taxpayer's information may be incorrect, because the AMT is designed to impose a higher, not lower, tax liability than the regular tax system.

Second, the taxpayer submitted an IRS regulation that provides the "definition of an audit reconsideration." The regulation implies that reconsideration is not allowed when an IRS action results in a refund. The taxpayer proffers that the IRS sent her the regulation to show that reconsideration of the deduction issue was not allowed because a refund had been issued. However, this information alone does not convince the Commission that the IRS did not rule on the deduction issue *and* issue a refund. Without more detailed information about the IRS actions, the Commission does not find it appropriate to determine the correct amount of the deduction and use that amount in determining the taxpayer's 2003 state taxable income. For

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<sup>1</sup> See *xxxxx v. Auditing Division*, USTC Appeal No. 03-0586 (May 24, 2004); *xxxxx v. Auditing Division*, USTC Appeal No. 03-0510 (January 1, 2005); *xxxxx v. Auditing Division*, USTC Appeal No 06-1408 (November 5, 2007).

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these reasons, the Commission sustains the Division's assessment of additional tax related to the disallowed deduction.

Credit for Taxes Paid to STATE 1. The taxpayer failed to claim a \$\$\$\$ credit on her 2003 tax return for taxes paid to STATE 1. The Division admits that the taxpayer would have been entitled to a refund of the \$\$\$\$ overpayment if she had claimed the refund within the three-year statutory timeframe. However, because the three-year period expired prior to the Division issuing its assessment and the taxpayer filing the appeal, the Division argues that this specific refund request is untimely. For this reason and because the Division did not address taxes paid to another state in its Statutory Notice, the Division contends that the taxpayer is precluded from having her 2003 deficiency reduced by the \$\$\$\$ overpayment.

The Commission disagrees. As long as a deficiency exists for the 2003 tax year, the Commission finds that the taxpayer is allowed to decrease the amount of the deficiency by any amounts that the taxpayer may have overpaid. Even though the taxpayer may be barred from receiving a refund of the \$\$\$\$ overpaid amount, the taxpayer may apply the overpayment to decrease her deficiency. The Commission notes that Sections 59-10-523 and 59-10-524 provide that the Division has assessed a "deficiency" in this matter. Accordingly, the taxpayer has appealed the deficiency, not the specific issue that gave rise to the deficiency. For these reasons, the Commission finds that the Division's deficiency assessment should be reduced by the \$\$\$\$ overpayment. The Commission believes that its decision is supported by a Utah Supreme Court decision addressing an overpayment of sales tax, specifically *Dupler's Art Furs, Inc. v. State Tax Commission*, 161 P.2d 788 (Utah 1945) (holding that a seller's overcollection and remittance of sales tax from taxpayers could be applied to the seller's *deficiency* for the same period).

DECISION AND ORDER

Based on the foregoing, the Commission finds that the Division's additional tax assessment of \$\$\$\$ should be reduced by \$\$\$\$ to \$\$. Interest should also be recalculated to reflect the revised deficiency. 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 taxpayer'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 \_\_\_\_\_, 2008.

\_\_\_\_\_  
Kerry R. Chapman  
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 \_\_\_\_\_, 2008.

Pam Hendrickson  
Commissioner

Marc B. Johnson  
Commissioner

D'Arcy Dixon Pignanelli  
Commissioner

**Notice:** If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from

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this order within thirty (30) days from the date of this order may result in a late payment penalty.

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**CONCURRENCE**

I concur in the judgment. Based on the somewhat confused evidence regarding the status of taxpayer's IRS appeal, I have no other choice. I write only to clarify one point that may or may not be relevant to this case, but might provide guidance in similar cases in the future.

The Auditing Division usually relies on the IRS determination of Federal Adjusted Gross Income as a starting point for determining Utah taxable income. In the past, the Division has declined to consider changing FAGI if, for any reason, the IRS refused to consider those changes. The majority opinion points out certain cases where we have required the Division to consider such corrections independently. Another circumstance that, in my opinion, would require the Division to independently consider the validity of itemized deductions would be a scenario where the taxpayer was subject to federal alternative minimum tax ("AMT").

If a hypothetical taxpayer's federal AMT is higher than the normal federal tax, AMT must be paid. Itemized deductions are generally disregarded in computing AMT. I could imagine a situation where a hypothetical taxpayer that claimed \$\$\$\$ of legal expenses as itemized deductions would pay the AMT. That taxpayer might also pay the AMT if he or she only claimed \$\$\$\$ of legal expenses. In such a circumstance, the IRS might well conclude that it did not need to determine whether \$\$\$\$ or \$\$\$\$ was the correct amount. The conclusion would be irrelevant to the taxpayer's final liability - which would be based on the AMT calculation without any deduction at all for legal expenses. In such a circumstance, it would be incumbent on the Division to make an independent determination of the appropriate amount of allowable legal fees, so the Utah tax could be properly computed.

R. Bruce Johnson  
Commissioner