08-1482
TAX TYPE: INCOME TAX
TAX YEAR: 2004 & 2005
DATE SIGNED: 6-15-2015
COMMISSIONERS: J. VALENTINE, M. CRAGUN, R. PERO

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER-1 & TAXPAYER-2, Petitioners, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 08-1482 Account No. ##### Tax Type: Income Tax Year: 2004 & 2005 Judge: Chapman

Presiding:
Kerry R. Chapman, Administrative Law Judge

Appearances:
For Petitioner: REPRESENTATIVE FOR TAXPAYERS 1 & 2, CPA (by telephone)
TAXPAYER-1, Taxpayer (by telephone)
For Respondent: RESPONDENT-1, from Auditing Division
RESPONDENT-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 June 1, 2015.

TAXPAYER-1 and TAXPAYER-2 ("Petitioners" or "taxpayers") have appealed Auditing Division's (the "Division") assessment of additional Utah individual income taxes for the 2004 and 2005 tax years. On June 3, 2008, the Division issued Notices of Deficiency and Audit Change for the 2004 and 2005 tax years, in which it imposed additional taxes and interest (calculated through July 3, 2008),[1] as follows:

Year	Tax	Penalties	Interest	Total
2004	$$$$$	$$$$$	$$$$$	$$$$$

1 Interest continues to accrue while any liability remains unpaid.

2005	$$$$$	$$$$$	$$$$$	$$$$$

The Division based it assessments on changes that the Internal Revenue Service ("IRS") primarily made to the taxpayers' 2004 and 2005 federal adjusted gross income ("FAGI"), as shown on IRS transcripts. The IRS increased the taxpayers' 2004 FAGI by $$$$$ and their 2005 FAGI by $$$$$. The taxpayers explained that the IRS changes were associated with S-corporations they owned and whose income flowed through to them for purposes of filing their personal income tax returns. The 2004 Statutory Notice shows that the $$$$$ increase in FAGI was due to the IRS's subtracting $$$$$ of repairs and maintenance expenses and adding $$$$$ of gross receipts/sales, which the taxpayers had claimed on Schedule E. The 2005 Statutory Notice shows that the $$$$$ increase in FAGI was due to the IRS's adding $$$$$ of gross receipts/sales, which the taxpayers had also claimed on Schedule E.

The taxpayers paid the IRS's assessments for the two years at issue in 2008 and/or 2009, but filed an appeal of the assessments with the IRS. The taxpayers went through two lengthy appeal processes at the IRS, but were unsuccessful in convincing the IRS to change any portion of the 2004 and 2005 *federal* assessments. While the taxpayers still believe that the IRS's assessments were erroneous, they have chosen not to appeal the assessments further to Tax Court because of the expense involved to do so. As a result, for *state* tax purposes, the taxpayers have elected not to challenge the $$$$$ increase to their 2004 FAGI and the $$$$$ increase to their 2005 FAGI, which were at issue in the IRS appeals and which were identified on the Statutory Notices as the reasons for the state assessments.

However, the taxpayers would like the Commission to make a change to their 2004 and 2005 FAGI's for a matter that was not addressed in the IRS appeals and that is not identified on the Division's Statutory Notices. The taxpayers stated that they have recently discovered an error affecting the amounts of their 2004 and 2005 FAGI's of which they were unaware when their appeals were before the IRS. They indicate that they can no longer approach the IRS about the error because their appeals with the IRS are concluded and because

they paid the taxes at issue more than two years ago. In addition, they indicate that the tax liability associated with the error is insufficient to warrant their going to Tax Court. Although they will not be able to have the error addressed at the federal level, they ask the Commission to address it for purposes of determining their 2004 and 2005 Utah tax liability.

The taxpayers explain that the error involves the IRS's reclassification of non-wage distributions (which had originally flowed through to them from one of their 100%-owned S-corporations) as "reasonable compensation" or wages for services rendered to the corporation. The taxpayers proffered IRS Form 4549 (Income Tax Examination Changes) ("Form 4549") to show that the IRS increased their 2004 wages by and $$$$$ their 2005 wages by $$$$$ because of its decision to reclassify the non-wage distributions as wages. The taxpayers are not contesting the IRS's decision to reclassify this income as wages.

However, because of the income reclassification, these wages were now subject to Social Security and Medicare employment taxes, whereas the non-wage distributions had not been. The taxpayers proffered IRS Form 4668 (Employment Tax Examination Changes Report) ("Form 4668") to show that the IRS also imposed employment taxes on their S-corporation in the amounts of $$$$$ for the 2004 tax year and $$$$$ for the 2005 tax year because of the reclassified wages. The taxpayers explained that under federal law, they were personally responsible for one-half of these employment taxes, while their S-corporation was responsible for the other one-half. The taxpayers also claim that federal tax law provides that the one-half of employment taxes for which their S-corporation is responsible is an allowable expense of the S-corporation that should have flowed through to Schedule E of their federal return, which would have reduced their FAGI's. They claim, however, that the IRS failed to allow this Schedule E expense when it calculated their FAGI's for 2004 and 2005. As a result, they contend that their FAGI's, as reflected in IRS records and used by the Division to determine their Utah tax liability, are overstated by amounts equal to one-half of the employments taxes that

were imposed for each year on the reclassified wages, which equates to $$$$$ for the 2004 tax year and $$$$$ for the 2005 tax year.

The taxpayers contend that the information found on Form 4549 shows that the IRS did not deduct the employment tax expenses on Schedule E of their federal returns when it issued the federal assessments that it later sustained. The taxpayers point out that Form 4549 shows that the IRS increased their 2004 wages by $$$$$ and decreased their 2004 Schedule E net income and expenses by $$$$$, which results in a net increase to 2004 FAGI of $$$$$ (which is equal to the change in FAGI identified in the Division's 2004 Statutory Notice). They explain that the $$$$$ decrease in their Schedule E net income and expenses is obtained by taking the $$$$$ of non-wage distributions that the IRS disallowed and subtracting the $$$$$ of adjustments that the IRS made to repairs and maintenance expenses and gross/receipts sales, adjustments which the Division identified in its 2004 Statutory Notice. The taxpayers claim that this analysis is sufficient to identify all components that comprise the IRS's 2004 Schedule E adjustment of $$$$$ and to show that the adjustment omits the expense deduction for the one-half of employment taxes paid by the S-corporation on the reclassified wages. For the same reasons, the taxpayers proffer that the Form 4549 information shows that the IRS's 2005 Schedule E adjustment also omits the employment tax expense deduction.[2] On this basis, the taxpayers ask the Commission to revise the Division's assessments to reflect FAGI's that are $$$$$ lower for the 2004 tax year and $$$$$ lower for the 2005 tax year.

The Division does not dispute the taxpayers' conclusion that they are entitled to expense deductions on Schedule E for one-half of the employment taxes the IRS imposed on Form 4668 because of the reclassified wages.[3] In addition, the Division stated that it is possible that the adjustments the taxpayers propose to the

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2 For the 2005 tax year, the Form 4549 shows that the only Schedule E adjustments made by the IRS were for the $$$$$ non-wage distribution that was disallowed and for the $$$$$ adjustment that the IRS made to gross/receipts sales, the adjustment identified in the Division's 2005 Statutory Notice.

3 The taxpayers did not cite any provision of the Internal Revenue Code to support their conclusion. However, the Division stated that it thought the taxpayers were probably correct. In addition, the Division was

Utah assessments are appropriate. However, the Division indicated that it would first want to see the taxpayers' Schedule E's for the years at issue before it agrees with the taxpayers' request to reduce their FAGI's. The Division stated that it is uncomfortable finding that the "netted" Schedule E adjustments shown on Form 4549 improperly excluded an adjustment for the employment taxes paid by the S-corporation without seeing more details on the taxpayers' tax documents. Specifically, the Division stated that it would like to see the taxpayers' Schedule E's so that it would be better able to "track through" the income and expenses shown on these documents. The taxpayers, however, did not have their Schedule E's to proffer at the hearing.[4] For these reasons, the Division asks the Commission to sustain its assessments and not to make the changes requested by the taxpayers.

APPLICABLE LAW

Utah Code Ann. §59-10-112 (2004)[5] 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."

UCA §59-1-1417 (2015)[6] provides that the burden of proof is upon the petitioner in proceedings before the Commission, with limited exceptions as follows:

> (1) In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:
> (a) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
> (b) whether the petitioner is obligated as the transferee of property of the person that

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given an opportunity to submit post-hearing information and declined the opportunity.

4 The Division, however, indicated that it would review any documents the taxpayers might provide to it after the hearing to see if the information on them was sufficient for it to accept the taxpayers' position.

5 UCA §§59-10-111 and 59-10-112 were the same in both 2004 and 2005, but were repealed in 2007. The definitions in these sections are currently found in UCA §59-10-103. However, it is the 2004 and 2005 versions of Utah law that are applicable to this appeal.

6 Prior to 2009, these burden of proof provisions were found at UCA §59-10-543 (since repealed).

> originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and
> (c) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income:
> (i) required to be reported; and
> (ii) of which the commission has no notice at the time the commission mails the notice of deficiency. . . .

DISCUSSION

The taxpayers have the burden of proof in this matter. The taxpayers believe that the Division's assessments overestimate their 2004 and 2005 Utah tax liabilities because the FAGI's on which they are based are erroneously high. The taxpayers are concerned that the FAGI's found in IRS records and on which the Division's assessments are based do not reflect Schedule E expense deductions to which they are entitled, specifically employment tax expenses for one-half of the Social Security and Medicare employment taxes associated with the 2004 and 2005 distributions that the IRS reclassified as wages.

The FAGI's on which the Division based the state assessments are the same FAGI's that are reflected in IRS records and that the IRS sustained after two IRS appeals. Sections 59-10-111 and 59-10-112 provide for Utah taxable income to be based on federal taxable income as defined in the Internal Revenue Code ("IRC"). As a result, the Tax Commission generally relies on federal taxable income, as reflected in IRS records, when determining Utah taxable income. Nevertheless, the Commission has, on occasion, independently reviewed a petitioner's evidence of federal taxable income instead of relying on IRS records where the petitioner was unable to contest the matter at the IRS, generally in situations where a federal deadline had expired and it was too late for the IRS to consider the matter.[7]

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7 One such case is *USTC Appeal No. 06-1408* (Initial Hearing Order Nov. 5, 2007), where the petitioner in that case had been told that the IRS considered the federal matter final and closed and where the petitioner proffered documentation showing that the IRS's revised FAGI was incorrect. In that case, the Commission reversed the Division's assessment, stating that:

> The Utah Code sections specify that state taxable income is federal taxable income **as defined**

In this case, the taxpayers contend that they were unable to have the merits of the Schedule E employment tax expense deductions reviewed by the IRS because the issue was not discovered until after their two IRS appeals had concluded. In addition, they explain that they paid the federal taxes at issue more than two years ago, which precludes another appeal at the IRS. For these reasons and because the Division indicated a willingness to consider the taxpayers' proposed FAGI reductions if the taxpayer were to submit their tax documents for review, the Commission should consider the taxpayers' evidence and decide whether it is sufficient to show that their 2004 and 2005 FAGI's should be reduced by the amounts they propose.

To show that their FAGI's should be reduced, the taxpayers must first show that the IRC allows a Schedule E expense deduction for the one-half of employment taxes that the S-corporation pays on wages. The taxpayers did not identify any IRC provision to show that the IRC allows such a deduction. The Division, however, appeared to agree with the taxpayer's argument that the IRC does allow such a deduction. Furthermore, the Division declined to submit a post-hearing document in which it could have shown that the IRC did not allow such a deduction. For these reasons, the Commission should accept the taxpayers' position that the IRC allows a Schedule E expense deduction for one-half of the employment taxes associated with the reclassified wages.[8]

> **in the Internal Revenue Code**, (sic) they do not tie the state taxable income to the federal taxable income **as determined by the IRS**. Certainly the Tax Commission will give great deference in the interpretation of the Internal Revenue Code to the IRS, as they are the experts in this area. However, where there is a clear error and the taxpayer was unable to have the merits reviewed by the IRS due to the statute of limitations or for other procedural reasons, the Commission concludes that it is appropriate to give consideration to the definitions provided in the Internal Revenue Code. (emphasis added).

The decision for this appeal, as well as other selected Commission decisions, can be viewed in a redacted format on the Tax Commission's website at http://www.tax.utah.gov/commission-office/decisions.

8 The Commission accepts the taxpayers' argument that such deductions are allowable under the IRC because the Division did not refute it. Furthermore, Sections 923 and 2648 of the 2015 U.S. Master Tax Guide (98th Ed.) appear to lend support the taxpayer's conclusions. However, should a party submit IRC provisions at a subsequent hearing that show otherwise, the Commission's decision could be different.

Next, the taxpayers must show that the FAGI's found in IRS records and on which the Division based the state assessments do not already incorporate a Schedule E expense deduction for one-half of the employments taxes the IRS imposed because of the reclassified wages. On Form 4549 and Form 4668, the taxpayers showed that in late 2007, an IRS examiner reclassified non-wage distributions by their S-corporation as wages and imposed employment taxes on these wages. The taxpayers filed their 2004 and 2005 returns prior to 2007. Accordingly, these employment taxes would not have been deducted on the federal returns that the taxpayers filed. Furthermore, the taxpayers' explanation as to why the "net" Schedule E adjustments shown on Form 4549 did not include a deduction for one-half of the employment taxes was convincing. As a result, it appears that the IRS omitted the Schedule E employment tax expenses when it made the examination changes shown on the Form 4549 proffered by the taxpayers.

The Form 4549 that the taxpayers proffered does not show FAGI amounts for either 2004 or 2005. As a result, it is unclear from this document alone whether the changes reflected on this form were the only changes that the IRS made to arrive at the FAGI's found in IRS records and which the Division used for its assessments. However, the Division's evidence indicates that the IRS only made one change that would have affected FAGI for each year at issue. Furthermore, the one change that the IRS made for each year is identical to the change shown on the Form 4549 proffered by the taxpayers.[9] For these reasons, a preponderance of the evidence shows that the FAGI's on which the Division based its assessments do not include the Schedule E employment tax expense deductions to which the taxpayers appear to be entitled. Accordingly, the Commission should find that the FAGI's on which the Division based its assessments should be reduced by $$$$$ for the 2004 tax year and $$$$$ for the 2005 tax year.

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9 The Division proffered two pages of IRS transcripts for each year. The IRS transcript for 2004 shows that the IRS only made one "additional tax assessed by examination" adjustment and that the amount of the adjustment was $$$$$ (which is same amount as the $$$$$ deficiency shown on Form 4549 for the 2004 tax year). Similarly, the IRS transcript for 2005 shows that the IRS only made one "additional tax assessed by examination" adjustment and that the amount of the adjustment was $$$$$ (which is same amount as the

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains the Division's assessments with one exception. The Commission finds that the FAGI's on which the Division based its assessments should be reduced by $$$$$ for the 2004 tax year and $$$$$ for the 2005 tax year. 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, or emailed, 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

or emailed to:

taxappeals@utah.gov

$$$$$ deficiency shown on Form 4549 for the 2005 tax year).

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

DATED this _____ day of _____, 2015.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.