

11-2709

TAX TYPE: INCOME TAX

TAX YEARS: 2005, 2006, 2007 & 2008

DATE SIGNED: 9-16-2013

COMMISSIONERS: B. JOHNSON, D. DIXON, 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. 11-2709

Account No. #####

Tax Type: Income

Tax Years: 2005, 2006, 2007 & 2008

Judge: Chapman

Presiding:

Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE FOR TAXPAYER, CPA (by telephone)
TAXPAYER 1, Taxpayer (by telephone)

For Respondent: RESPONDENT, 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 2, 2013.

TAXPAYER-1 and TAXPAYER-2 (“Petitioners” or “taxpayers”) are appealing Auditing Division’s (the “Division”) assessment of additional individual income tax for the 2005, 2006, 2007, and 2008 tax years. On August 17, 2011, the Division issued Notices of Deficiency and Audit Change (“Statutory Notices”) to the taxpayers, in which it imposed additional tax and interest (calculated as of September 16, 2011)¹ for the four tax years at issue, as follows:

¹ Interest continues to accrue until any tax liability is paid.

<u>Year</u>	<u>Tax</u>	<u>Penalties</u>	<u>Interest</u>	<u>Total</u>
2005	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$
2006	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$
2007	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$
2008	\$\$\$\$	\$\$\$\$	\$\$\$\$	<u>\$\$\$\$</u> \$\$\$\$

The Division imposed the assessments after determining that the Utah taxable income the taxpayers claimed on their amended Utah returns for the four tax years at issue was lower than the taxpayers’ federal adjusted gross income (“FAGI”) for these years, as shown on Internal Revenue Service (“IRS”) transcripts. The Division increased the taxpayer’s Utah taxable income to match the FAGI amount shown in IRS records for each year.

The taxpayers explained that TAXPAYER-1 and his two brothers own an S Corporation and that each brother claims a portion of the S Corporation’s income on his individual income tax returns. The taxpayers explained that TAXPAYER-1 had reported his portion of the S Corporation’s gains for the 2005, 2006, 2007, and 2008 tax years when they filed their original federal and Utah returns for these years. In 2009, however, the S Corporation had a net operating loss (“NOL”) of approximately \$\$\$\$\$. The taxpayers proffer that they decided to carry TAXPAYER-1 portion of the 2009 NOL back for the four years at issue by filing amended federal and Utah returns for these years.²

The taxpayers claim that they filed amended federal and Utah returns for the four years at issue in the spring of 2010, in which they claimed NOLs in the following amounts:

<u>Tax Year</u>	<u>Amount of 2009 NOL Claimed on Amended Returns</u>
2005	\$\$\$\$
2006	\$\$\$\$
2007	\$\$\$\$
2008	\$\$\$\$

² The taxpayers explained that for losses incurred in the 2009 tax year, the IRS allowed a taxpayer to carry the NOL back five years, whereas the carryback period had previously been two years. The Division proffered that it was aware of the change allowing a five-year carryback period for losses incurred in 2009.

Upon the Tax Commission receiving the amended 2010 Utah returns, it refunded the amounts shown due on the returns. The Division subsequently audited the refunds and determined that the taxpayers were not due the amounts they had been refunded because the IRS had not accepted the taxpayers' amended federal returns on which they had claimed the same NOLs for federal tax purposes.

The Division claims that IRS transcripts do not show that the taxpayers filed amended federal returns for the four years at issue. The taxpayers proffer that they filed the amended federal and Utah returns at the same time. They admit that the IRS did not accept the amended federal returns and proffer that the IRS responded to the amended returns by sending them a letter in which it requested more information. The taxpayers, however, did not proffer a copy of this letter at the Initial Hearing.

REPRESENTATIVE FOR TAXPAYERS, the taxpayers' CPA, stated that after receiving the IRS's request for more information, the taxpayers sent the IRS a "follow-up" package of information. He stated that the IRS "dragged its feet" for a couple of years before telling him verbally that it would not allow the NOLs for 2005, 2006, 2007 and 2008 because the taxpayers had missed a deadline to make an election concerning their NOLs.³ REPRESENTATIVE FOR TAXPAYERS stated that the IRS has told him that it had sent a letter to the taxpayers informing them of this decision. The taxpayers, however, claim that they never received this letter from the IRS. In addition, the taxpayers were unable to get a copy of this letter from the IRS to submit at the Initial Hearing. REPRESENTATIVE FOR TAXPAYERS stated that he has attempted to get a copy of this letter from the IRS and that the IRS employees with whom he has spoken inform him that the letter exists in the IRS system, but that they cannot access it.

³ As a result, the taxpayers claim that the IRS has not allowed them to carry any portion of TAXPAYER-1's 2009 NOLs back to a prior year.

The taxpayers have not filed an appeal with the IRS concerning its decision to disallow the NOLs they claimed for the four years at issue. The taxpayers also have not contacted the IRS's Taxpayer Advocate Service office in an attempt to have the matter reopened at the IRS.

The taxpayers assert that the amendments they made (i.e., the NOLs they claimed) for the four tax years are valid, regardless of the IRS's refusal to acknowledge them. As a result, they ask the Commission to accept the amended Utah returns they filed in the spring of 2010 and to reverse the Division's audits that disallow the NOLs they claimed for the four years at issue. They acknowledge that the IRS has not told them that they would have been entitled to claim the NOLs if they had filed the election form in a timely manner.

Nevertheless, they believe that evidence is available that shows that the taxpayers were entitled to claim the NOLs for the four years at issue. REPRESENTATIVE FOR TAXPAYERS proffered that he also prepared amended federal and Utah returns for TAXPAYER-1 two brothers for the four years at issue, on which they claimed the same NOLs that the taxpayers claimed. REPRESENTATIVE FOR TAXPAYERS stated that the IRS accepted the amended federal returns from TAXPAYER-1 two brothers and that the Tax Commission has not rejected the amended Utah returns from TAXPAYER-1 brothers. The taxpayers ask the Commission to accept their amended Utah returns and to reverse the Division's audit assessments because they are legally entitled to NOLs for these four years.

The taxpayers, however, have not provided any documentary evidence to show that TAXPAYER-1 circumstances are similar to his brothers' circumstances or that the IRS has accepted the NOLs claimed by TAXPAYER-1 brothers for the four years at issue. In addition, the taxpayers have provided no information to show that the amounts of NOLs that the taxpayers claimed for the four years at issue were correctly calculated.

The Division asks the Commission to sustain its assessments. The Division relies on the fact that the taxpayers' amended federal returns on which they claimed the NOLs have not been accepted by the IRS. The Division acknowledged that the Commission has issued several decisions where it has disregarded the FAGI

amounts shown on IRS records when determining Utah tax liability. The Division admitted, however, that it did not know the facts of these cases and whether the facts of the instant case are similar to or different from the prior cases.

The Division also warned against allowing NOL carrybacks that the IRS has not accepted because the taxpayers could carry the 2009 NOL forward for federal tax purposes. The Division claimed that if the taxpayers carried the 2009 NOL forward on their federal returns, it could do so on its Utah returns, as well. The Division claimed that this could result in the taxpayers' being able to receive the 2009 NOL twice, once for the four years at issue and again for whatever year or years they were able to carry the NOL forward.

The taxpayers admitted that they are still able to carry the 2009 NOL forward, but claim that they can only carry it forward for five years, which would end with the 2014 tax year. The taxpayers claim that the S Corporation no longer makes as much income as it once did, which results in the taxpayers' not being able to claim all of the 2009 NOL going forward, whereas they could claim it all going back for the four years at issue.

APPLICABLE LAW

Utah Code Ann. §59-10-103 (2008)⁴ defines “adjusted gross income” and “taxable income’ or ‘state taxable income,’” as follows:

- (1) As used in this chapter:
 - (a) "Adjusted gross income":
 - (i) for a resident or nonresident individual, is as defined in Section 62, Internal Revenue Code; or
 -
 - (f) “Federal taxable income”:
 - (i) for a resident or nonresident individual, means taxable income as defined by Section 63, Internal Revenue Code; or
 -
 - (w) "Taxable income" or "state taxable income":
 - (i) . . . for a resident individual, means the resident individual's adjusted gross income after making the:

4 For the 2005 and 2006 tax years, the definition of “federal taxable income” was found in Utah Code Ann. §59-10-111 (since repealed), and the definition of “state taxable income” was found in Utah Code Ann. §59-10-112 (since repealed).

- (A) additions and subtractions required by Section 59-10-114; and
- (B) adjustments required by Section 59-10-115;

....

UCA §59-1-1417 (2013) 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 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 Division has proffered evidence showing that the IRS has not approved the NOL carrybacks that the taxpayers claimed on amended federal income tax returns they filed for the 2005, 2006, 2007, and 2008 tax years. As a result, the Division contends that the taxpayers should not be able to claim the NOLs on the amended Utah returns they filed for these years. The taxpayers, on the other hand, claim that the IRS has erroneously disallowed NOLs to which they entitled for the four years at issue. They claim that the Commission should allow them to claim the NOLs for Utah tax purposes because they were legally entitled to them for federal tax purposes.

The Division relies on the argument that Utah law requires a person's Utah taxable income to be based on federal taxable income as shown in IRS records. The Division admitted that the Commission has not accepted this argument in a number of prior appeals where clear evidence exists to show that the correct

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amount of a petitioner's federal taxable income is different from the amount shown in IRS records. The Tax Commission has independently reviewed a petitioner's evidence of federal taxable income in situations where that petitioner was unable to contest the IRS action, generally in situations where a deadline had expired and it was too late to have the matter considered by the IRS. One such case is *USTC Appeal No. 06-1408* (Initial Hearing Order Nov. 5, 2007) ("Appeal No. 06-1408"),⁵ in which documentation was proffered that supported the petitioner's original federal and Utah returns and indicated that the revised FAGI determined by the IRS was incorrect. In that case, the Commission reversed the Division's assessment, even though it reflected FAGI as shown in the IRS's records, stating that:

The Utah Code sections specify that state taxable income is federal taxable income as defined 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).

In *Appeal No. 06-1408*, the petitioner had been told that the IRS considered the federal matter final and closed. In *USTC Appeal No. 08-1313* (Initial Hearing Order Mar. 19, 2009), however, the Commission indicated a willingness to independently review taxable income in certain situations where a petitioner might still have been able to have the IRS review the federal matter. In this case, the Division suggested that the IRS's action that increased the taxpayer's FAGI was incorrect because it appeared that the petitioner had merely reported his unemployment insurance income on the wrong line of his federal return. Given these circumstances, the Commission held:⁶

5 Decisions cited herein and certain other decisions issued by the Utah State Tax Commission are available for review in a redacted format at <http://www.tax.utah.gov/commission-office/decisions>.

6 The Commission has issued other decisions in which it determined that federal taxable income, as shown in IRS records, was incorrect and in which it did not use the amount from IRS records to establish Utah taxable income. See *USTC Appeal No. 03-0586* (Initial Hearing Order May 24, 2004), in which the IRS's Taxpayer Advocate Service office provided a letter in which it agreed that the petitioner's correct federal

The taxpayer in this appeal has not been told that the federal matter is closed. . . . Regardless, the Commission finds that the evidence proffered by the Division shows that the taxpayer's original Utah return reflects the correct amount of "federal taxable income" as defined in Sections 59-10-111 and 59-10-112. Accordingly, under these specific circumstances, the Commission finds that the Division's assessment is incorrect, even though it reflects the FAGI currently recognized by the IRS. As a result, the Commission reverses the Division's assessment.

Nevertheless, the taxpayers' circumstances appear to be most similar to another case the Commission considered, specifically *USTC Appeal No. 07-0365* (Findings of Fact, Conclusion of Law, and Final Decision Feb. 23, 2010). In this case, the Commission considered a petitioner who, like TAXPAYER-1, was a member or partner in a pass-through entity. The petitioner in that case argued that the IRS had increased the FAGI of both himself and his partner in regards to income they earned through the pass-through entity. The petitioner claimed that the IRS eventually reduced his partner's FAGI, but refused to adjust his FAGI in a similar manner. In that case, the Commission declined to adjust the petitioner's FAGI to match the changes made by the IRS to his partner's FAGI because the petitioner did not present evidence to show what adjustments the IRS made to the partner's FAGI and because the petitioner did not present evidence to show that the adjustments the IRS made to the partner's income would also be appropriate adjustments for the petitioner.

The taxpayers have the burden of proof in this case. They, like the petitioner in *Appeal No. 07-0365*, have not proffered any documentary evidence to show how the IRS treated TAXPAYER-1 two brothers for the four tax years at issue. In addition, they have not proffered evidence to show that the amounts of NOLs that the taxpayers claimed on their amended tax returns were determined correctly. The Commission generally bases Utah taxable income on the federal taxable income shown by IRS records. When an exception to this general policy has been made, the Commission has been presented with sufficient evidence to clearly show that the IRS records do not reflect the correct amount of the person's federal taxable income. The taxpayers have

adjusted income was lower than the amount shown in IRS records, but that it could not adjust the amount in IRS records because the statute of limitations had expired; and *USTC Appeal No. 03-0510* (Initial Hearing Order Jan. 10, 2005), in which the Division admitted that IRS records appeared to reflect an incorrect amount

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not proffered evidence to show that they were entitled to the amounts of NOLs that they claimed on their tax returns for the four years at issue.

Even had the taxpayers submitted clear and convincing evidence to show that they were entitled to the NOLs they claimed on their federal and Utah returns for these years, the Commission may want to consider carefully before accepting the taxpayer's amended Utah returns because the NOLs can not only be carried back, but can also be carried forward. If the Commission, but not the IRS, were to accept the NOL carrybacks for the four years at issue, the taxpayers would be entitled to carry the NOLs forward for federal purposes, which could also impact Utah taxable income for these future years. Regardless, the taxpayers have not appealed the IRS action concerning the NOLs for these years, and they have not proffered evidence to show that they were entitled to the amounts of NOLs that they claimed for these years. For these reasons, the taxpayers have not met their burden to show that any of the Division's assessments are incorrect. Accordingly, the Commission should sustain the Division's assessments for the 2005, 2006, 2007, and 2008 tax years.

Kerry R. Chapman
Administrative Law Judge

of federal taxable income where the petitioner had missed the statute of limitations to file an amended return.

DECISION AND ORDER

Based on the foregoing, the Commission sustains the Division's audit assessments for the 2005, 2006, 2007, and 2008 tax years. 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 _____, 2013.

R. Bruce Johnson
Commission Chair

D'Arcy Dixon Pignanelli
Commissioner

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.