12-268
TAX TYPE: INCOME TAX
TAX YEARS: 2008 & 2009
DATE SIGNED: 4-8-2013
COMMISSIONERS: B. JOHNSON, D. DIXON, R. PERO
EXCUSED: M. CRAGUN
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 12-268 Account No. ##### Tax Type: Income Tax Year: 2008 & 2009 Judge: Chapman

Presiding:
Kerry R. Chapman, Administrative Law Judge

Appearances:
For Petitioner: TAXPAYER, Taxpayer
For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General
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 January 15, 2013.

TAXPAYER ("Petitioner" or "taxpayer") is appealing Auditing Division's assessments of additional individual income tax for the 2008 and 2009 tax years. On December 20, 2011, Auditing Division issued Notices of Deficiency and Audit Change to the taxpayer, in which it imposed additional tax, penalties, and interest (calculated as of January 19, 2012) for the 2008 and 2009 tax years, as follows:

Year	Tax	Penalties	Interest	Total
2008	$$$$$	$$$$$	$$$$$	$$$$$
2009	$$$$$	$$$$$	$$$$$	$$$$$
				$$$$$

At issue is whether gambling losses that completely offset gambling income for federal income tax purposes have a similar "zero" tax effect under Utah law for the years at issue. Auditing Division imposed its assessments after receiving information from the Internal Revenue Service ("IRS") showing that the taxpayer reported his federal adjusted gross income ("FAGI") and his federal itemized deductions differently on his 2008 and 2009 Utah returns than had been reported for federal purposes.

On his 2008 federal return, TAXPAYER reported $$$$$ of gambling income as part of his FAGI and claimed $$$$$ of gambling losses as one of his itemized deductions. Similarly, on his 2009 federal return, he reported $$$$$ of gambling income as part of his FAGI and claimed $$$$$ of gambling losses as one of his itemized deductions. Both parties agree that this is the method by which gambling income and gambling losses are reported to the IRS for federal tax purposes. They also agree that for federal tax purposes, TAXPAYER's gambling losses completely offset his gambling income so that his gambling activity, which resulted in "net" losses, did not increase his federal tax liability for the 2008 or 2009 tax year.

TAXPAYER provided evidence that shows that for both 2008 and 2009, he incurred net losses from his gambling activity. Because the IRS allows him to completely offset his gambling income by his gambling losses for federal purposes, he contends that he should also be allowed to do the same for state tax purposes. Otherwise, he argues, he will be required to pay Utah income tax on an activity for which he has incurred losses.

TAXPAYER determined that if he reported his gambling income as part of his FAGI and his gambling losses as part of his itemized deductions, as set forth on Utah's 2008 and 2009 Utah returns, he would end up paying Utah income tax on his gambling income without being allowed any, or hardly any, deduction for his gambling losses. Because he believes that this result is unfair and unconstitutional, he took various actions to "rectify" the situation when he completed his 2008 and 2009 Utah returns.

First, TAXPAYER filed Utah returns on which he reported his gambling income as part of his FAGI and his gambling losses as part of his federal itemized deductions. On these returns, however, he also claimed an equitable adjustment equal to the amount of his gambling income for each year. In response to TAXPAYER's taking this equitable adjustment on his returns, Taxpayer Services Division issued a letter to him on June 2, 2009, in which it informed him that it was removing the equitable adjustment. In the letter, Taxpayer Services Division also instructed the taxpayer that "[t]he amount carried to line 4 of TC-40 from your federal return should include the gambling gain and/or loss from the federal schedules."

In response to Taxpayer's Services Division's letter, TAXPAYER amended his 2008 and 2009 returns in an attempt to comply with the instructions provided in the letter. He included the amounts that he considered his gambling gain and his gambling loss on line 4 of the TC-40 (which is the line where a taxpayer reports his FAGI). For 2008, for example, he amended his return to include on line 4 the $$$$$ of gambling income that was part of his FAGI, but to exclude his $$$$$ of gambling losses that were part of his federal itemized deductions. This had the effect of decreasing his FAGI by the amount of his gambling losses. Because he had reported his gambling losses on line 4 (as he understood the instructions from Taxpayer Services Division), he reduced his federal itemized deductions, as reported on line 12 of the return, by $$$$$. TAXPAYER amended his 2009 Utah return in a similar manner. TAXPAYER contends that his amended returns should be accepted because they comply with the Tax Commission's own guidance on the issue as found in the letter from Taxpayer Services Division.

Auditing Division determined that TAXPAYER's amended returns were incorrect. Auditing Division also admitted at the Initial Hearing that the instructions given by Taxpayer Services Division in its June 2, 2009 letter are, at best, confusing and may even be incorrect. Auditing Division claims that because TAXPAYER's gambling income is part of his FAGI, it must be included as part of the FAGI reported on line 4 on the Utah return. In addition, it claims that because his gambling losses are part of his itemized deductions

for federal purposes, they must be included as part of the itemized deductions reported on line 12 of the Utah return and may not be deducted from line 4. In its assessments, Auditing Division made these changes to TAXPAYER's amended returns.

TAXPAYER claims that Auditing Division's assessments result in his having to pay Utah income tax on his gambling income even though he has proof to show and the IRS is aware that he lost money on his gambling activities in each year at issue. Auditing Division acknowledges that Utah law now produces the result that TAXPAYER describes. Auditing Division explained that until 2008, Utah law provided that itemized deductions could be fully deducted from FAGI when determining Utah taxable income. Auditing Division explained, however, that in 2008, the Legislature changed the Utah tax code to provide for a "flat tax," which resulted in a taxpayer's federal itemized deductions no longer being deducted from FAGI to determine a person's Utah taxable income. Instead, federal itemized deductions are now part of a tax credit calculation for Utah tax purposes. Auditing Division explained that this change to Utah law provides for the unique circumstance where the taxpayer's gambling income is subject to Utah taxation with little or no reduction in tax liability in account for the taxpayer's gambling losses.

Auditing Division further explained that for federal tax purposes, the IRS treats gambling income and gambling losses differently than it treats business income and losses. Whereas business income and losses are considered together with the total gain or loss deducted from FAGI, gambling income and losses are treated differently. If a taxpayer itemizes deductions and has gambling losses, he or she may deduct the gambling losses as an itemized deduction. However, the gambling losses reported as an itemized deduction for federal purposes cannot exceed the amount of gambling income reported as FAGI. Because of the way the IRS treats gambling income and gambling losses, Auditing Division contends that Utah law clearly provides that Utah must consider the taxpayer's gambling income as part of his FAGI and his gambling losses as part of his

federal itemized deductions for state tax purposes, which it admits will result in state taxation of all or most of the taxpayer's gambling income.

TAXPAYER contends that unless the Commission accepts his amended Utah returns as submitted, part of his gambling income will be subject to Utah taxation, even though his losses far exceeded his winnings for the years at issue. He contends that such a result is a violation not only of equal protection, but also of the Commerce Clause of the United States Constitution. He claims that his equal protection rights would be violated because Utah taxpayers who gamble would pay higher taxes than Utah taxpayers who do not gamble. He claims that the Commerce Clause would be violated because Utah's denial of the full offset would be a regulation and tax on gambling activities in another state.

Auditing Division stated that it was aware of TAXPAYER's constitutional concerns, but had not had time to research them. It noted, however, that the Commission does not have jurisdiction to address the constitutionality of Utah tax statutes, but stated that the taxpayer would need to bring up any constitutional arguments at the Commission hearing in order to preserve his arguments for court action.

Auditing Division stated that the circumstances in this case are not ones that would qualify for an adjustment pursuant to Utah Code Ann. §59-10-115, which provides for an adjustment to FAGI if the taxpayer would otherwise receive a double tax benefit or suffer a double tax detriment under Utah's individual income tax laws. Auditing Division contends that the taxpayer is not suffering a double tax detriment because his gambling income is only being taxed once for Utah income tax purposes. Auditing Division also argues that a taxpayer does not suffer a double tax detriment on the basis that the IRS treats certain losses differently than the state. Lastly, Auditing Division stated that it would not object to the Commission waiving the interest at issue in the appeal because of the advice given by Taxpayer Services Division.

APPLICABLE LAW

Utah Taxable Income. For the tax years at issue, Utah Code Ann. §59-10-103 (2008) defines "adjusted gross income," "federal taxable 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:
>
> (A) additions and subtractions required by Section 59-10-114; and
> (B) adjustments required by Section 59-10-115;
> . . . .

Itemized Deductions and Credit Against Utah Tax Liability. For the years at issue, UCA §59-10-1018 (2008) authorizes a taxpayer to claim a nonrefundable tax credit against the Utah tax otherwise due. The credit is calculated using the amount of standard or itemized deductions that the taxpayer deducts on his or her federal income tax return, as follows in pertinent part:

> . . . .
> (2) Except as provided in Section 59-10-1002.2, and subject to Subsections (3) through (5), a claimant may claim a nonrefundable tax credit against taxes otherwise due under this part equal to the sum of:
> (a) (i) for a claimant that deducts the standard deduction on the claimant's federal individual income tax return for the taxable year, 6% of the amount the claimant deducts as allowed as the standard deduction on the claimant's federal individual income tax return for that taxable year; or
> (ii) for a claimant that itemizes deductions on the claimant's federal individual income tax return for the taxable year, the product of:
> (A) the difference between:
> (I) the amount the claimant deducts as allowed as an itemized deduction on the claimant's federal individual income tax return for that taxable year; and

(II) any amount of state or local income taxes the claimant deducts as allowed as an itemized deduction on the claimant's federal individual income tax return for that taxable year; and

(B) 6%; and

(b) the product of:

(i) 75% of the total amount the claimant deducts as allowed as a personal exemption deduction on the claimant's federal individual income tax return for that taxable year; and

(ii) 6%.

. . . .

(4) The tax credit allowed by Subsection (2) shall be reduced by $.013 for each dollar by which a claimant's state taxable income exceeds:

(a) for a claimant who has a single filing status, $12,000;

(b) for a claimant who has a head of household filing status, $18,000; or

(c) for a claimant who has a joint filing status, $24,000.

. . . .

Adjustments to Adjusted Gross Income. For the years at issue, UCA 59-10-115 (2008) allows for adjustments to adjusted gross income under certain circumstances, as follows in pertinent part:

(1) The commission shall allow an adjustment to adjusted gross income of a resident or nonresident individual if the resident or nonresident individual would otherwise:

(a) receive a double tax benefit under this part; or

(b) suffer a double tax detriment under this part.

. . . .

Interest. UCA §59-1-401(13) (2013) provides that "[u]pon making a record of its actions, and upon reasonable cause shown, the commission may waive, reduce, or compromise any of the penalties or interest imposed under this part."

Utah Admin. Rule R865-1A-42(2) ("Rule 42") (2013) provides guidance concerning the waiver of interest, as follows in pertinent part:

(2) Reasonable Cause for Waiver of Interest. Grounds for waiving interest are more stringent than for penalty. To be granted a waiver of interest, the taxpayer must prove that the commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error.

. . . .

Burden of Proof. 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:

> 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:
> (1) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
> (2) 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
> (3) 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;
> (a) required to be reported; and
> (b) of which the commission has no notice at the time the commission mails the notice of deficiency.

DISCUSSION

Utah Taxable Income. For Utah income tax purposes, "taxable income" is defined in Section 59-10-103(1)(w)(i) to mean "adjusted gross income after making the: (A) additions and subtractions required by Section 59-10-114; and (B) adjustments required by Section 59-10-115[.]" Section 59-10-103(1)(a)(i) provides that "adjusted gross income" is as the same as defined in the Internal Revenue Code ("IRC"). Both parties agree that gambling income reported to the IRS is part of federal adjusted gross income ("FAGI). Because "adjusted gross income" is the same for both state and federal purposes, TAXPAYER's gambling income should be reported as Utah "taxable income" unless it is subject to the "additions and subtractions required by Section 59-10-114" or the "adjustments required by Section 59-10-115."

Utah Code Ann. §59-10-114 provides for a number of specifically listed additions and subtractions from FAGI to arrive at Utah taxable income. None of the subtractions, however, pertain to gambling income. Accordingly, TAXPAYER's gambling income is Utah taxable income unless it is subject to the adjustments required by Section 59-10-115.

Section 59-10-115 provides that adjustments can be made to FAGI if the taxpayer will receive a double tax benefit or double tax detriment under Utah law. Such adjustments, if appropriate, can be made as "equitable adjustments" on the Utah tax return. TAXPAYER deducted an amount equal to his gambling income as an equitable adjustment on his original 2008 and 2009 returns.

There is no claim of a double tax benefit in this case. There is also no double tax detriment that would qualify as an equitable adjustment under Section 59-10-115. Although the taxpayer's gambling income and gambling losses are completely offset at the federal level, the fact that they are not offset at the state level does not result in a double tax detriment. In its assessments, Auditing Division is only taxing the taxpayer's gambling income once. For these reasons, no adjustments should be made to the taxpayer's FAGI pursuant to Section 59-10-115. For 2008 and 2009, the taxpayer's gambling income should be included as part of his Utah "taxable income."

Itemized Deductions. For the years at issue, Section 59-10-1018 authorizes a taxpayer to claim a nonrefundable tax credit against the Utah tax that would otherwise be due. The credit is calculated using the amount of standard or itemized deductions that the taxpayer deducts on his or her federal income tax return. In addition, Section 59-10-1018 provides for a "phase-out" of the credit as a taxpayer's income increases. Utah law no longer provides for a taxpayer's itemized deductions to offset income. As a result, the taxpayer should report his gambling losses (which are part of his federal itemized deduction) as itemized deductions for state purpose, too. Then, the amount of itemized deductions will be used to determine whether he qualifies for a Section 59-10-1018 tax credit. The taxpayer is not allowed to move his gambling losses from his itemized deductions to line 4 of the TC-40, as he did on his amended Utah returns (which has the affect of completely offsetting his gambling income).

Auditing Division has made changes to TAXPAYER's 2008 and 2009 returns to reflect Utah law and has assessed him accordingly. TAXPAYER contends that it is arbitrary to tax someone on an activity on

which he is losing money. Federal law, however, treats gambling activity differently than it treats other activities. For example, business income and losses are netted before the net income or net loss is added or subtracted from FAGI. Federal law does not allow a taxpayer with net gambling losses to deduct those losses against income, as opposed to a taxpayer with business losses. Furthermore, federal law does not allow a taxpayer with net gambling losses to deduct those losses unless the taxpayer itemized deductions. As a result, federal law taxes the gambling income of some taxpayers who have net losses. It does not appear arbitrary that Utah law may do the same.

Constitutional Arguments. The taxpayer contends, nevertheless, that Utah's tax laws are arbitrary and that they are unconstitutional because they violate equal protection and the Commerce Clause of the United States Constitution. The Commission, however, does not have jurisdiction to address the taxpayer's constitutional arguments. *See State Tax Commission v. Wright*, 596 P.2d 634 (Utah 1979), in which the Utah Supreme Court stated that "[a]lthough the Tax Commission must of necessity interpret the taxing statutes and make determinations as to their applicability, it has been stated that 'it is not for the tax commission to determine questions of legality or constitutionality of legislative enactments'" (*citing Shea v. State Tax Commission*, 101 Utah 209, 120 P.2d 274 (Utah 1941)). *See also Nebeker v. State Tax Comm'n*, 34 P.3d 180 (Utah 2001). However, as Auditing Division explained, the taxpayer would need to bring up any constitutional arguments at the Commission hearing in order to preserve his arguments for court action.

Interest. Interest is assessed because the taxpayer has had use of money that should have previously been paid to the Tax Commission. Nevertheless, pursuant to Section 59-1-401(13), the Commission is authorized to waive penalties and interest upon a showing of "reasonable cause." The taxpayer has not been assessed any penalties. Accordingly, only a waiver of interest will be considered.

The criteria to waive interest are more stringent than the criteria to waive penalties. In accordance with Rule 42(2), interest is waived only if a taxpayer shows that the Commission gave erroneous information or

took inappropriate action that contributed to the error. Auditing Division stated that it would not object to a waiver of interest in this matter because of the confusing instructions found in the June 2, 2009 letter issued by Taxpayer Services Division. In that letter, the taxpayer was instructed that "[t]he amount carried to line 4 of TC-40 from your federal return should include the gambling gain and/or loss from the federal schedules." This advice was, at best, confusing. For this reason and because Auditing Division has no objection, the Commission should find that "reasonable cause" exists to waive the interest at issue.

Summary. In summary, Auditing Division's assessments of additional tax for 2008 and 2009 should be sustained. However, all interest at issue in the matter should be waived.

_____

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains Auditing Division's assessments with one exception. The Commission waives all interest associated with the assessments. 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.