

APPEAL # : 19-369

TAX TYPE: Income Tax

TAX YEAR: 2010

DATE SIGNED: 1/29/2021

COMMISSIONERS: J.VALENTINE, M.CRAGUN, AND R.ROCKWELL

EXCUSED/RECUSED: L.WALTERS

BEFORE THE UTAH STATE TAX COMMISSION	
TAXPAYER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	INITIAL HEARING ORDER Appeal No. 19-369 Account No. ##### Tax Type: Income Tax Tax Year: 2010 Judge: Phan

Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER'S REP-1, Attorney At Law
TAXPAYER

For Respondent: RESPONDENT'S REP-1, Manager, Income Tax Auditing
RESPONDENT'S REP-2, Senior Auditor

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission pursuant to an appeal filed by Petitioner ("Taxpayer") under Utah Code §59-1-501 of a Utah individual income tax audit deficiency for tax year 2010. An Initial Hearing was held in this matter on DATE, in accordance with Utah Code Ann. §59-1-502.5. The Initial Hearing was held by teleconference. Petitioner is appealing a Utah individual income tax audit deficiency in the amount of \$\$\$\$\$ in tax and \$\$\$\$\$ in interest, which had accrued as of the date of the deficiency notice. The Notice of Deficiency and Audit Change had been issued on DATE. Interest continues to accrue on the unpaid balance. No penalties were assessed with the audit.

APPLICABLE LAW

Utah imposes income tax on individuals who are residents of the state, in Utah Code §59-10-104(2010)¹ as follows:

...a tax is imposed on the state taxable income of every resident individual...

State taxable income is defined in Utah Code §59-10-103(1)(y)(i) as follows:

"State taxable income" subject to Subsection 59-10-302(2), for a resident individual other than a resident individual described in Subsection (1)(y)(iii), means the resident individual's federal taxable income after making the: (A) additions and subtractions required by Section 59-10-114; and (B) adjustments required by Section 59-10-115 . . .

Utah Code §59-10-103(1)(k)(i) provides the statutory definition of federal taxable income:

"Federal taxable income" for a resident or nonresident individual, means taxable income as defined by Section 63, Internal Revenue Code . . .

Taxable income is defined in the Internal Revenue Code at 26 U.S.C. 63 (2010) as follows:

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).

Utah Code §59-1-1417 provides that the burden of proof is upon the petitioner in proceedings before the Commission:

In a proceeding before the commission, the burden of proof is on the petitioner. . . .

The Commission has been granted the discretion to waive penalties and interest. Utah Code Ann. §59-1-401(14) provides, "Upon 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."

The Commission has promulgated Administrative Rule R861-1A-42 to provide additional guidance on the waiver of penalties and interest, as follows in pertinent part:

¹ This Decision cites to provisions in effect for the 2010 tax year.

- (1) 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.

DISCUSSION

The Taxpayer had not filed Utah or federal 2010 individual income tax returns when those returns had been due in 2011. On DATE, the Taxpayer filed a Utah individual income tax return for 2010. When reviewing the late filed return, Respondent (“Division”) found no record of a federal return having been filed based on shared information the Division is able to obtain from the Internal Revenue Service. Therefore, the Division indicated at this hearing that it was not able to verify the Taxpayer’s filing status, federal adjusted gross income, number of exemptions and the itemized deductions that the Taxpayer had claimed on his Utah return for tax year 2010. The Division then audited the return, changing the Taxpayer’s filing status, exemptions, income and deductions as follows:

REDACTED TABLE

On his 2010 Utah return, which the Taxpayer filed in DATE, the Taxpayer had claimed \$\$\$\$\$ of individual income tax due on Line 40 of that return. The Taxpayer stated that after filing the return he has paid this tax amount in full. The Division’s audit indicates an additional \$\$\$\$\$ in tax due for 2010. The Division explained that being unable to verify the filing status, exemptions, FAGI and deductions because no federal return had been filed, the Division looked to the Wage and Income Transcript it had obtained from the IRS. The Wage and Income Transcript did show a number of different types of income items that had been reported as paid to the Taxpayer in 2010. Reported items included some wage income, K-1 income, interest, dividends, debt cancellation and other income, including two Form 1099-S documents that showed “Gross Proceeds” from sales of property. By far the largest dollar amounts reported on the Wage and Income Transcript were the gross proceeds on these Forms 1099-S. One showed gross proceeds in the amount of \$\$\$\$\$ and indicated a partial address of “ADDRESS-1.” The other showed gross proceeds in the amount of \$\$\$\$\$ and a partial address of “ADDRESS-2.” These two Form 1099-S documents totaled \$\$\$\$\$. The Division explained at the hearing that the FAGI the Division concluded in its audit of \$\$\$\$\$ came from the various income sources indicated on the 2010 Wage and Income Transcript from the IRS, including these “gross proceeds” from the two property sales. In fact, most of the Division’s FAGI came from the “gross

proceeds.” There were also a number of 1098 Mortgage Interest Statements reported on the Wage and Income Transcript, along with some debt cancellation income.

It was the Division’s argument through the appeal process and at the hearing that the Division wanted the Taxpayer to file a federal return for tax year 2010 and then see if the IRS accepted the return. If the IRS accepted the return, the Division indicated it would then accept the same filing status, FAGI, deductions and exemptions as had the IRS. The Taxpayer and his representative explained, however, why they had not filed a federal return after being audited by Utah in 2019 for tax year 2010. The Taxpayer represented that he has never been contacted by the IRS asking him to pay federal taxes for 2010 or file a federal return. This statement is supported by the federal Account Transcript that shows no assessment for 2010. It was the Taxpayer’s representative’s statement that it was unlikely that the IRS would now ask for a return to be filed for that long ago. The implication of this, although not directly acknowledged by the Taxpayer at this hearing, is that there could be a significant downside for the Taxpayer if he filed a 2010 federal return now.

Although it may be simpler for the Division to ask the Taxpayer to file a federal return and then wait and see if the IRS accepts that return, there is not a statutory argument the Division offered to support the Division having the authority to require the Taxpayer to file a 2010 federal return. “State taxable income” is defined at Utah Code Subsection 59-10-103(1) as “the resident individual’s federal taxable income” with some additions and subtractions under Section 59-10-114 & 115. This language does make it clear that ultimately the state taxable income is based on the federal definition of taxable income. However, as noted by the Utah Supreme Court, the state is not precluded from issuing an assessment in situations where the IRS has not issued one. See *Jensen v. State Tax Commission*, 835 P.2d 965, 970 (Utah 1992); and *Nelson v. Auditing Div., Utah State Tax Comm’n*, 903 P.2d 939 (Utah 1995).

The Utah State Tax Commission does give deference to the IRS on the determination of federal taxable income in situations where the IRS audited a taxpayer’s federal return and made some adjustment to the federal adjusted gross income.² In this matter, there was no federal return filed and thus no federal return accepted by the IRS. The IRS has not, at this point, issued a

² See *Utah State Tax Commission, Findings of Fact, Conclusions of Law and Final Decision, Appeal Nos. 12-1345* (December 12, 2016) and *No. 06-1408* (Nov. 5, 2007). See also *Utah State Tax Commission Appeal Nos. 14-580, 13-1292, 12-2967, 12-2963, 11-2709 and 08-1482*.

nonfiling or other audit against the Taxpayer for the 2010 tax year. Based on these facts, the Tax Commission needs to make an independent determination based on the evidence before it, but the Taxpayer does have the burden of proof to show that the audit is incorrect.

Regarding the burden of proof, at the hearing the representative for the Taxpayer argued that the Notice of Deficiency had stated only that the Taxpayer's Utah return was adjusted "based upon available information" and did not say what the source of the information was. It was his contention that this was a "naked" assessment because there was no foundation for the assessment. The Taxpayer's representative argued that the presumption of correctness usually granted to a notice of deficiency does not apply to a naked assessment. However, his contention appears to be based on federal law principles. In this matter, based on Utah law, specifically Utah Code §59-1-1417, the burden of proof is on the Taxpayer, not the Division. Therefore, the Taxpayer needs to provide evidence that the audit assessment is incorrect. The Commission considers the Taxpayer's evidence offered at the Initial Hearing to determine if the Taxpayer has established that each of the Division's changes to his return are incorrect.

I. Filing Status & Exemptions

The Division had disallowed the Taxpayer's filing status and the three exemptions which he claimed on the Utah tax return that he filed. Regarding the Division's change of the Taxpayer's filing status from Head of Household to Single and changing the number of personal exemptions from three to one, the Taxpayer provided a signed declaration as well as an Order of Parentage that indicated he was the father of two children who were minors in 2010. The Taxpayer was not married to the children's mother, but based on his declaration and proffer at the Initial Hearing the two children and their mother resided with him full time from when they were born through 2010 and for several more years until he and their mother separated. He stated that the children's mother was not employed in 2010 and he provided all their financial support in that year. The Order of Parentage was signed in 2016, after the Taxpayer separated from the children's mother, but it did indicate that he was the father of the two children, one having been born in 2002 and one in 2007. Additionally, it indicated that his children's mother was unemployed at that time and the Taxpayer could claim the children as dependents until their mother obtained employment.

The Taxpayer and his representative proffered that the Taxpayer had filed with head of household status in years prior and for years after 2010 and that filing status had been accepted by the Tax Commission. The Division did not refute this. Another factor to support his filing status was the IRS Account Transcript for tax year 2010, which the Division had offered at the hearing

to show that no federal return had been filed for 2010. That transcript did indicate the Taxpayer's filing status was "head of household." The Division pointed out that this would merely be a carryover from prior years' returns, but it does support that status had been accepted for the prior year. With all of the evidence offered by the Taxpayer on this point, the Taxpayer has supported that his filing status was head of household and that he was entitled to the three personal exemptions that he had claimed on his Utah return.

II. Federal Adjusted Gross Income

The biggest item that the Division had adjusted in the audit was to increase the Taxpayer's FAGI from the \$\$\$\$ that the Taxpayer had claimed on his Utah return, to \$\$\$\$\$. The Taxpayer did have his accountant prepare a "pro forma" federal return, which was never filed with the IRS, to calculate out what his 2010 federal adjusted gross income was, which he then used to calculate his Utah taxable income. The Taxpayer explained that he was in serious financial hardship in 2010 and risked losing his residence and other properties that he owned. Some of his properties were foreclosed on during that year. He stated that he owned two adjacent parcels of property that were being used as a car dealership and a night club at ADDRESS-3. He was able to sell the two parcels together in one transaction in 2010 for \$\$\$\$\$. This was the "gross proceeds" as stated on one of the Form 1099-S documents. The Taxpayer pointed out that the \$\$\$\$ gross proceeds from the sale did not account for purchase price, costs and accounting depreciation. The Taxpayer had submitted a declaration in this matter on which he stated that he had purchased this property in the DATE time frame for "around \$\$\$\$" and he made improvements for "approximately \$\$\$\$\$, total". The second property he was able to sell was the property where the gross proceeds had been reported as \$\$\$\$\$. This was a residential property, which he had leased to tenants. For this property, he explained in his declaration that he had purchased the property in the same time frame for "approximately \$\$\$\$" and it had been vacant and fell into disrepair in DATE. He states that in 2010 they had remodeled the property for "approximately \$\$\$\$\$ total."

Although the Taxpayer provided as evidence the closing statements for when he sold these two properties, he did not provide the closing statement for when he bought these properties, or support like receipts, or a line item total regarding the expenses he had paid to fix up the properties. Furthermore, in review of the pro forma federal return it does not appear that he had claimed all of these parcels on that return, so the return itself does not support what the

Taxpayer had stated in the declaration. Form 4797 Sales of Business Property, which had been prepared as part of his 2010 pro forma federal return, indicates in Part III, a sale of one of the STREET-1 parcels for \$\$\$\$\$ and a total gain from that of \$\$\$\$\$. The Taxpayer had sold two adjacent parcels on STREET-1 for a total of \$\$\$\$\$. The second STREET-1 parcel is not accounted for in that section of the return, and was not readily apparent in any other section. Also, it is not readily apparent that the residential property that sold for \$\$\$\$\$ was included in the return either, although the return is complicated and there were a number of rental properties listed with rental income, expenses and ultimately losses claimed on the return. The Taxpayer's claim that his taxable gain from these sales was far less than the total proceeds is reasonable. However, the Taxpayer has the burden of proof in this matter and has not provided sufficient information to establish the correct amount of net proceeds from the sale at this hearing to support the Taxpayer's claimed federal adjusted gross income.

III. Itemized Deductions.

The final items changed on the returns are the Division's disallowance of itemized deductions. The Taxpayer had claimed \$\$\$\$\$ in itemized deductions and the Division disallowed the itemized deductions and instead allowed only the standard deduction of \$\$\$\$\$. Schedule A of the pro forma federal return provided the following, which made up the \$\$\$\$\$ of itemized deductions:

REDACTED TABLE

The largest of the itemized deductions claimed is the mortgage interest deduction. The evidence presented in this matter indicated three different amounts of mortgage interest in regards to the Taxpayer's residence. When preparing his pro-forma return, the Taxpayer had provided the information to the tax preparer that the amount of mortgage interest for his residence had been \$\$\$\$\$. However, as evidence for the hearing he provided a copy of a Form 1098 from Dovenmuehle Mortgage, Inc., Servicer for Mountain America Credit Union, that appears to have been sent to him by the mortgage company. This document stated that the Mortgage Company had received \$\$\$\$\$ in mortgage interest from the Taxpayer in 2010. This form also listed a break out of each payment he had made, when it was received and how much of the payment went to the interest. This form did provide that the last 4 digits of the mortgage company's federal identification number were ##### and that the account number on this loan was #####. This statement also indicated that \$\$\$\$\$ in property taxes had been paid for this property. However, the Division had submitted the IRS Wage and Income Statement, which indicated three Form

1098s had been filed on the Taxpayer's loan account with the number ending in #####. The names and account numbers on these statements were partially redacted but it appeared that three of the seven Forms 1098 related to the Taxpayer's residence. One of those three 1098s stated in the space to list submission type "original document" and that reported \$\$\$\$ in interest paid. Another stated for submission type "corrected document" and that reported \$\$\$\$ in mortgage interest paid. A third said it was an "amended document" and indicated \$\$\$\$ mortgage interest. Based on what was reported to the IRS and the manner in which the information appeared on the federal Wage and Income Transcript, there were three Forms 1098 submitted to the IRS regarding the mortgage interest for the residential property, each with a very different number. The Wage and Income Transcript does not provide a date for when these documents were submitted, and it is unclear if the "corrected document" or the "amended document" had been the final submission from the mortgage company. The copy of the paper Form 1098 provided by the Taxpayer does indicate payments had been received throughout the year and it listed the portion of those payments that went to interest and the portion that went to principal, supporting that interest was paid on the loan during the year. However, the amount of interest listed on that document corresponds with the 1098 reported to the IRS listed as the "original document." It does appear that the mortgage company later changed the amount to either the "corrected document" or the "amended document." Based on this, the evidence submitted is unclear as to what would be the correct deduction for the mortgage interest given the "amended" Form 1098 indicating \$\$\$\$ paid. There did appear to be loans and interest paid on other properties as well based on the Forms 1098 reported on the IRS Wage and Income Transcript. However, mortgage interest on business properties would not be deductible on schedule A and the Taxpayer was requesting a deduction based on the mortgage for his residence. The Taxpayer does have the burden of proof and the evidence on this point is conflicting. Therefore the Taxpayer has not supported the mortgage interest deduction.

For the Property Tax Deduction, on the pro forma return the Taxpayer had listed \$8,982 in real estate taxes on Schedule A. At the hearing, the representative stated that this was the property tax amount paid for the Taxpayer's residence. The representative stated in his Prehearing Brief, at page 4, "The Form 1098, which is attached as exhibit D states that the amount of property taxes paid during 2010, in the total amount of \$\$\$\$\$. This amount also corresponds to the approximate amount the petitioner believes he paid in property taxes on his residence for that year." The Form 1098 he provided in Exhibit D, however, which appears to be for the Taxpayer's residence indicated property taxes paid in the amount of \$\$\$\$\$. In his Exhibit D, there were three

tax notices for three other properties, none of which were the residence. The assertion that all \$\$\$\$\$ of property tax was for the Taxpayer's residence was also not supported by information contained in Exhibit C to the Taxpayer's Prehearing Brief. In Exhibit C, attached to the pro forma return, was a page titled Supporting Schedules. That explains how the \$\$\$\$\$ in property tax had been derived, showing it as the total of property tax on three separate properties as follows:

REDACTED TABLE

The \$\$\$\$\$ does correspond to the tax amount listed on the Form 1098 regarding the mortgage interest on the Taxpayer's residence. It is not clear and it was not explained at the hearing how the property tax on the other properties would qualify for this deduction, as the Schedule A deduction for property tax does not apply to properties used for business purposes. The Taxpayer, may, however, deduct the property tax paid on his primary residence on Schedule A and has provided evidence to support a \$\$\$\$\$ deduction.

The last item deducted on Schedule A is sales tax. The Taxpayer chose to deduct sales tax rather than state and local income tax on that schedule. He had listed a deduction of \$\$\$\$\$ in sales tax. As that deduction can be calculated via a table based on a person's income range, number of exemptions and the address where they reside, the amount could be calculated in that manner without further verification. However, because the amount of the property tax deduction that has been supported of \$\$\$\$\$ and the amount of the sales tax deduction of \$\$\$\$\$ when added together is only \$\$\$\$\$, the Taxpayer is better off with the standard deduction of \$\$\$\$\$ that the Division had allowed in the audit.

Therefore, although the Taxpayer has presented evidence that he was entitled to claim head of household filing status and three exemptions, the Taxpayer did not at the Initial Hearing sufficiently support that he should be allowed the itemized deductions that he has claimed on his pro forma return.

The Taxpayer has not met the burden of proof to show that federal adjusted gross income determined by the Division in its audit is incorrect. The Division should recalculate the 2010 Utah individual income tax audit, however, to allow the head of household status and three exemptions which the Taxpayer has sufficiently supported at this hearing.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission orders the Division to recalculate the Taxpayer's 2010 Utah individual income tax audit tax amount by allowing the head of household filing status and three exemptions. 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

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

DATED this _____ day of _____, 2021.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Rebecca L. Rockwell
Commissioner

Lawrence C. Walters
Commissioner

Notice of Payment Requirement: Any balance due as a result of this order must be paid within thirty (30) days of the date of this order, or a late payment penalty could be applied.