

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 15056
[Redacted],)	
)	DECISION
Petitioners.)	
_____)	

On August 2, 2000, the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination to [Redacted] (petitioners), proposing additional income tax and interest for the taxable year 1998 in the total amount of \$2,511. The petitioners filed a timely protest and petition for redetermination. A hearing was held on May 4, 2001. The Tax Commission, having reviewed the file, hereby issues its decision.

It is the petitioners' position that it is inappropriate for the Tax Commission to treat a loss from a certain partnership as an Idaho net operating loss. The petitioners contend that to do so would: (1) be in violation of an existing agreement with the Idaho State Tax Commission, (2) result in an improper matching of expenses with income, (3) be in violation of the federal statute that requires due process, (4) deny the petitioner "equal" protection of the laws in contravention of Section 1 of the Fourteenth Amendment, (5) burden interstate commerce in contravention of the commerce clause of Section 8 of Article 1 of the U. S. Constitution, (6) discriminate against the petitioners as nonresidents in favor of residents and this deprives the petitioner and other nonresidents of the privileges and immunities of citizens and residents of the state of "Idaho," in violation of Section 2 of Article 4 of the U. S. Constitution.

FACTS

The petitioners are Washington residents whose only connection in 1998 to Idaho is from their investment as limited partners in two partnerships doing business in Idaho.

[Redacted] In 1985, the petitioners invested \$100,000 in [Redacted] (hereafter “ABC”). The petitioners have held their limited partnership interest in ABC from 1985 through 1998. At the time of ABC’s dissolution in 1998, the petitioners held a 6.125% limited partnership interest. ABC appears to have owned and operated a hotel located in Idaho since ABC’s formation in 1985. The Idaho apportionment factor for tax year 1998 was 100%.

In 1998, after having sold the partnership’s real and tangible personal property, ABC dissolved and filed final federal and Idaho partnership income tax returns. The petitioners’ Schedule K-1 (Form 1065) for 1998 reflects the following:

<u>Description</u>	<u>Amount</u>
Ordinary income	\$150,211
Interest income	\$201
Section 1231 gain	\$79,854
Charitable contributions	\$14
Nondeductible expenses	\$4,126
Distribution of money	\$74,869

[Redacted]

In 1998, Mr. [Redacted] (hereafter the “husband”) held a 4.95% limited partnership interest in [Redacted] (hereafter “XYZ”). It appears that the husband has held this investment since at least 1979. In 1998, XYZ’s Idaho apportionment factor was 100%. In 1998, the petitioners reported the rental real estate income generated by XYZ as Idaho source income.

Unlike ABC, XYZ did not sell its assets or dissolve in 1998. The petitioners’ Idaho source net income or loss from ABC and XYZ is reflected in Exhibit 1.

Idaho Income Tax Returns

In 1998, the petitioners filed a delinquent 1996 Idaho individual income tax return. The petitioners filing of the 1996 Idaho income tax return appears to be as a result of discussions

(see Exhibit 2) between the representatives for ABC and the Tax Commission's Tax Discovery Bureau.

A schedule was attached to the petitioners' 1996 Idaho income tax return, which reflected a \$501,053 "passive activity loss" carryforward. The carryforward of \$27,357 was used to offset the petitioners' 1996 Idaho source income. Additionally, in a letter dated September 4, 1997, the petitioners' representative stated again that "[t]he deduction represents a passive activity loss carryforward from 1995." (Exhibit 3)

The petitioners 1996 and 1997 Idaho income tax returns do not appear to have been audited by the Tax Commission's Income Tax Audit Bureau (ITA). In 2000, ITA audited the petitioners' 1998 Idaho return and issued a Notice of Deficiency Determination. ITA made the following adjustments to the amount of taxable income reported by the petitioners for 1998:

<u>Description</u>	<u>Amount</u>
Idaho taxable income as reported	\$ 225
Audit adjustments:	
Disallowed Idaho capital gains deduction	47,912
Disallowed Idaho net operating loss deduction	49,795
Increase in allowable itemized deductions and personal exemptions	<u>-64,443</u>
Idaho taxable income per the Notice of Deficiency Determination	<u>\$33,489</u>

In addition to the amount of Idaho net operating loss disallowed as a deduction in 1998, the amount of Idaho net operating loss carryforward available as a deduction in years subsequent to the taxable year 1998 was reduced from \$244,730 to zero. ITA's recalculation of the amount of Idaho net operating loss carryforward into the taxable year 1998 is reflected in Exhibit 4.

The petitioners' representative disagrees with ITA's disallowance of ABC's loss carryforwards and claims that "treating these losses as NOL would be reasonable if the taxpayers were in an active trade, however, the taxpayers were passive investors. The taxpayers filed their

Idaho income tax returns reporting these losses as passive. We feel that the auditor's reclassification of these losses, as net operating losses is clearly inappropriate."

LAW AND ANALYSIS

Before reviewing ITA's treatment of the losses from ABC and XYZ, it should be mentioned that ITA, in addition to disallowing a portion of the loss carryover deduction claimed by the petitioner in 1998, disallowed the petitioners' deduction of an Idaho capital gains deduction. The disallowance of the petitioners' Idaho capital gain deduction was made in accordance with Idaho Code Section 63-3022H. Since the petitioners are not protesting the disallowance of the Idaho capital gains deduction, no additional discussion need be held on this adjustment.

The Tax Commission will now focus its attention on ITA's disallowance of a portion of the loss carryforward deduction. In 1998, Idaho Code Section 63-3022 stated, in pertinent part:¹

63-3002. Declaration of intent. It is the intent of the legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act identical to the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income, to the end that the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in the Idaho law; to achieve this result by the application of the various provisions of the Federal Internal Revenue Code relating to the definition of income, exceptions therefrom, deductions [etc.]

The Idaho legislature has defined taxable income for state tax purposes as follows: "the term "taxable income" means federal taxable income as determined under the Internal Revenue Code." ² The Idaho Supreme Court in *Potlatch Corp. v. Idaho State Tax Comm'n*, 128 Idaho 387, 913 P.2d 1157 (1996) stated, "Idaho taxable income is the same as federal taxable income, except that it is "adjusted" according to the subsections of I.C. § 63-3022." (Emphasis added).

¹ For the time period at issue, 1979 through the end of 1998, Idaho Code Section 63-3002 has been amended twice. The amendments made in 1993 and 1995 are not material to the case currently before the Tax Commission.

² Idaho Code Section 63-3011B as added by 1995 Idaho Session Laws, Volume 1, Chapter 111, Section 4, page 347.

For nonresident individuals in 1998, the term "Idaho taxable income" includes only those components of Idaho taxable income as computed for a resident, which are derived from or related to sources within Idaho. Idaho Code Section 63-3026A. Therefore, unless an Idaho adjustment exists, the income or loss from the rental real estate activity and the income or loss from a trade or business activity would be included in the calculation of Idaho taxable income and in the calculation of an Idaho net operating loss.³ The petitioners do not dispute that, for federal income tax purposes, the rental real estate loss generated by the XYZ and the ordinary loss from ABC's trade or business activities were allowed as a deduction in arriving at a federal taxable income in a taxable year prior to 1998. The petitioners are not claiming that a suspended federal loss carryforward exists at the federal level due to Internal Revenue Code Sections 465, 469 or 704. The petitioners have not identified an Idaho adjustment that existed in 1998 that would remove ABC's Idaho loss from a trade or business activity or XYZ's loss from its Idaho rental real estate activity from the calculation of an Idaho net operating loss in prior taxable years and treat them as a suspended passive loss carryforward to taxable year 1998. Therefore, under Idaho law, the losses from ABC and XYZ are included in the calculation of an Idaho net operating loss and the petitioners' Idaho net operating loss is subject to the time period for carrying an Idaho net operating loss forward.

Violates an Agreement with the Tax Commission

The petitioners argue that, when the petitioners agreed to file their 1996 Idaho income tax return, ABC had entered into negotiations with the Tax Commission in which "the limited partners were granted the preservation of their 1985 through 1996 net operating loss carryforward in consideration of getting them to file." The petitioners' representative has not

³ The Idaho statute that governed the calculation of an Idaho net operating loss for tax years 1979 through 1994 can be found in Exhibit 5.

provided the Tax Commission with any formal written agreement signed by both parties that supports the petitioners' position. The petitioners' representative points to a schedule attached to the 1996 Idaho income tax return in which the losses being claimed by the petitioner were described as a "passive activity loss carryforward" as evidence that the Tax Commission has accepted the petitioners' classification of the loss carryforward as well as the years from which the losses are being carried.

On February 18, 1998, the Bureau Chief for the Tax Discovery Bureau (TDB) sent to ABC's representative a letter clarifying requests made by ABC (Exhibit 2). Nothing in that letter specifically discusses a waiver of the time period in which the petitioners can claim their Idaho net operating loss carryforward. Even if the letter contained a discussion on the time period for carrying an Idaho net operating loss forward, "[t]he government is not estopped by previous acts or conduct of its agents with reference to the determination of tax liabilities . . . nor will the mistakes or misinformation of its officers estop [the state] from collecting the tax." *State ex rel. Williams v. Adams*, 90 Idaho 195, 409 P.2d 415 (1965).

Violates the Income and Matching Principle

The petitioners' representative believes that "the auditor has commingled federal and state law. In doing so, he has not allowed for the proper matching of state revenue and expenses and in doing so has created phantom income."

"Matching" is a term used to describe the accounting principle involving attempts to associate related deductions and income in the same accounting period. Matching, however, is a desired goal of financial accounting, but it has not been cast as an overriding rule of tax accounting. See *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 603-604 (1986); *Eastman Kodak Co. v. United States*, 534 F.2d 252, 255-256 (1976); *RLC Industries Co. and*

Subsidiaries v. Commissioner, 98 T.C. 457, 497 (1992). The mere desirability of matching expenses with income will not necessarily sustain a taxpayer's deduction. See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 541 (1979).

As previously discussed, the petitioners have failed to identify an Idaho adjustment that would remove ABC's Idaho loss from a trade or business activity or XYZ's loss from its Idaho rental real estate activity from the calculation of an Idaho net operating loss and treat the losses as an adjustment in arriving at Idaho taxable income in 1998. Since ABC's prior year losses from a trade or business are a component of an Idaho net operating loss, the Idaho legislature has clearly placed a limit on the timeframe a taxpayer can offset a net operating loss against future income.

Violates Various Provisions of the United States Constitution

Basically, the petitioners' representative argues that for Idaho to not allow the losses incurred in prior taxable years by ABC from being used to offset the gain on the sale of ABC's Idaho property would be in violation of various provisions of the United States Constitution. The petitioners' representative cites *Shaffer v. Carter*, 252 U.S. 37, 40 S.Ct. 221, 64 L.Ed. 445 (1920), as support for his position. The representative states:

The case cited indicates that it is permissible for a state to "permit residents to deduct from their gross income losses incurred within or without the state, while nonresidents may deduct only those incurred within and without the state." The auditor's [ITA's] position is exactly opposite from this position, in that he is forcing the taxpayers to reduce their Idaho basis in the property because federal law allowed them to offset other income against the losses generated for federal reporting purposes."

The Tax Commission disagrees with the petitioners' representative's interpretation of the findings in *Schafer*. In *Shaffer*, a taxpayer contended that the Oklahoma Income Tax Law violated both the privileges and immunities clause of article IV and the equal protection clause of

the Fourteenth Amendment. The law permitted residents to deduct from their gross income all losses, wherever incurred, but permitted nonresidents to deduct losses incurred in Oklahoma only. The Court disagreed and specifically noted that the difference in treatment did not result from unfriendly discrimination.

The difference . . . is only such as arises naturally from the extent of the jurisdiction of the State in the two classes of cases, and cannot be regarded as an unfriendly or unreasonable discrimination. As to residents it may, and does, exert its taxing power over their income from all sources, whether within or without the state, and it accords to them a corresponding privilege of deducting their losses, wherever these accrue. As to nonresidents, the jurisdiction extends only to their property owned within the state and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources.

It appears to the Tax Commission that the same concept found in *Shaffer* applies in this case. As to residents, Idaho law exerts its taxing authority over their income from all sources, whether within or without the state; and it accords to the residents the corresponding privilege of offsetting their losses including any Idaho net operating loss carryforwards against their income. As to nonresidents, the jurisdiction extends only to Idaho source income with nonresidents accorded the privilege of offsetting their current year losses from Idaho sources and any Idaho net operating loss carryforward against their current year Idaho source income. However, both residents and nonresidents are subject to the same statute of limitations the Idaho legislature has placed on the number of years that an Idaho net operating loss can be carried forward and offset against future income. Thus it appears that the issue at hand is simply the result of the natural differences between the state's jurisdiction to tax residents versus nonresidents. Therefore, under the reasoning of *Schafer*, it appears that Idaho's treatment of the loss satisfies the various constitutional safeguards referred to by petitioners.

FINDING

It is well established in Idaho law that a taxpayer claiming a deduction, exemption, or credit bears the burden of establishing his or its entitlement to the same, both as to law and fact. Further, statutes allowing deductions and exemptions are "construed strongly against the taxpayer." *Potlatch Corp. v. Idaho State Tax Comm'n*, 128 Idaho 387, 913 P.2d 1157, 1159 (1996), *citing Hecla Mining Co. v. Idaho Tax Comm'n*, 108 Idaho 147, 151, 697 P.2d 1161, 1165 (1985). The petitioners have not met their burden of establishing their entitlement to the deductions at issue.

WHEREFORE, the Notice of Deficiency Determination dated August 2, 2000, is hereby APPROVED AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1998	\$2,262	\$0	\$437	\$2,699

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' rights to appeal this decision is enclosed with this decision.

DATED this ____ day of _____, 2001.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2001, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]
[REDACTED]

Receipt No. [Redacted]

ADMINISTRATIVE ASSISTANT 1