

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 15161
[Redacted],)	
)	DECISION
Petitioners.)	
_____)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the Idaho State Tax Commission (Commission) dated October 13, 2000 asserting additional income tax, penalty, and interest in the total amounts of \$102 and \$13,516 for 1996 and 1997, respectively.

There are two issues to be addressed in this decision. The first is whether passive losses properly allowable for federal purposes in prior years should be allowed in the year of disposition of an activity for Idaho purposes. The second issue is whether certain capital gain treated as ordinary income for federal purposes should be eligible for the Idaho capital gains deduction. The amount of itemized deductions allowed was also adjusted by the auditor. This adjustment was not contested by the petitioner. Therefore, it will not be further addressed in this decision.

The petitioners, during the years here in question, were nonresidents of Idaho. The petitioners owned a limited partnership interest in a partnership doing business in Idaho. They apparently acquired such interest during 1984. The petitioners' allocable share of the operating results of the partnership's operation in most years was a passive loss (pursuant to Internal Revenue Code § 469). The petitioners were entitled to deduct these passive losses for federal purposes during years prior to the disposition of their investment in the partnership (years not pertinent to this docket). The partnership sold its assets in 1997. In 1997, when the partnership sold its assets, the partnership reflected gains pursuant to Internal Revenue Code § 1231 from the disposition of the assets.

On Schedule E of the petitioners' 1997 federal income tax return, they reflected a loss from the operation of entities operating in Idaho in the amount of \$3,827. However, on their Idaho return, they reflected losses of \$134,759 without explanation regarding the source of the additional \$130,932 of losses. The auditor disallowed this claimed loss.

The petitioner subsequently submitted additional information to support the claimed losses. Based upon this additional information, the Commission finds that the petitioners were entitled to a net operating loss carryforward to 1997 in the amount of \$77,833 rather than the loss as claimed by the petitioners.

Idaho Code §63-3002 stated:

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 (personal and otherwise), accounting methods, taxation of trusts, estates, partnerships and corporations, basis and other pertinent provisions to gross income as defined therein, resulting in an amount called "taxable income" in the Internal Revenue Code, and then to impose the provisions of this act thereon to derive a sum called "Idaho taxable income"; to impose a tax on residents of this state measured by Idaho taxable income wherever derived and on the Idaho taxable income of nonresidents which is the result of activity within or derived from sources within this state. All of the foregoing is subject to modifications in Idaho law including, without limitation, modifications applicable to unitary groups of corporations, which include corporations incorporated outside the United States. (Underlining added.)

The amount in question for this issue is the difference between the amount allowed by the auditor as a net operating loss and the amount claimed by the petitioners as a passive loss carryforward. Idaho Code § 63-3022 indicated that "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" The amount in question was not included in the

computation of federal taxable income for 1997. The petitioners have not cited any portion of Idaho Code which would support their position that the additional amount should be allowed. The petitioners have set forth a logical argument for their position which might have been an appropriate way for the law to have been written. However, the Commission is not to be making the law as it sees fit, but instead enforcing the law as written. The Idaho Supreme Court has addressed such situations. In one such case, the Court stated:

Taxpayer urges that ambiguous language of the statute should be so construed as to avoid socially undesirable or oppressive results. It may be agreed, where legislative language is ambiguous, and other rules of statutory construction do not control, the court should consider social and economic results. But in this instance we do not find the statutes involved to be ambiguous; no exemption is granted and the legislative intent is to impose a tax on residents of this state measured by taxable income *wherever derived*. In such case our duty is clear. We must follow the law as written. If it is socially or economically unsound, the power to correct it is legislative, not judicial. John Hancock Mutual Life Insurance Co. v. Neill, 79 Idaho 385, 319 P.2d 195 (1957).

Herndon v. West, 87 Idaho 335, 339 (1964).

There is at least some similarity between this case and the cases of Potlatch Corporation and Extended Systems, Inc. v. Idaho State Tax Commission, 128 Idaho 387, 913 P.2d 1157 (1996). In these cases, the taxpayers were seeking deductions not specifically set out in the Idaho Code. Potlatch Corporation was seeking a deduction for contributions to an employee stock ownership plan for which it took a related credit on its federal return. Extended Systems sought a deduction for expenditures for research and development for which it took a related credit on its federal income tax return. In deciding these cases, the Idaho Supreme Court stated, in part:

We begin our analysis with the statute that declares the legislature's intent concerning the use of the Internal Revenue Code for state tax purposes.

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 the 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.]. . . .

I.C. § 63-3002 (Supp.1995) (emphasis added). The legislature has defined taxable income for state tax purposes, as follows:

The term "taxable income" means "taxable income" as *defined* in section 63 of the Internal Revenue Code, *adjusted* as follows: [several subsections follow]. . . .

I.C. § 63-3022 (1989) (emphasis added). The Internal Revenue Code defines taxable income for a corporation to mean "gross income minus deductions *allowed* by [Chapter 1]." I.R.C. § 63(a) (emphasis added).

[2] In construing these statutes, we are directed by *Bogner* "to enforce the law *as written*." 107 Idaho at 856, 693 P.2d at 1058. If there is any ambiguity in the law concerning tax deductions, the law is to be construed strongly against the taxpayer. Hecla Mining Co. v. Idaho Tax Comm'n, 108 Idaho 147, 151, 697 P.2d 1161, 1165 (1985). Applying these principles of construction to the statutes that are involved in the present case, we conclude that federal taxable income is determined by deducting from gross income only those deductions "allowed" by chapter 1 of the Internal Revenue Code. Idaho taxable income is the same as federal taxable income, except that it is "adjusted" according to the subsections of I.C. § 63-3022. I.C. § 63- 3002 indicates that this was the intent of the legislature.

While I.R.C. §404 allowed Potlatch a deduction for ESOP contributions, I.R.C. § 44G(c)(5) disallowed this deduction to the extent of any credit taken for the same contributions. These are both portions of Chapter 1 of the Internal Revenue Code. Therefore, the deductions for ESOP contributions claimed by Potlatch were not "allowed" by Chapter 1 and were not subtracted from federal gross income in arriving at federal taxable income, as "defined" in I.R.C. § 63. Idaho taxable income means the same as federal taxable income, subject to adjustment as provided in the subsections of I.C. § 63-3022. There is no subsection of I.C. § 63-3022 that would adjust taxable income by allowing the ESOP contributions as deductions.

Likewise, while I.R.C. § 174 allowed ESI to deduct a portion of R & D expenses, I.R.C. § 280C(c) disallowed this deduction to the extent of any credit determined under I.R.C. § 41(a). All of these sections are part of Chapter 1 of the Internal Revenue Code. Therefore, the deductions for R & D expenses claimed by ESI and denied by the Commission were not "allowed" by Chapter 1 and were not subtracted from federal gross income in arriving at federal taxable income as "defined" in I.R.C. § 63. There is no subsection of I.C. § 63-3022 that would adjust taxable income by allowing these R & D expenses as deductions.

The denial of these deductions is not at odds with *Bogner*. In *Bogner*, the Court ruled that an individual taxpayer could claim a deduction on her state income tax return that she did not claim on her federal return because she took a tax credit instead. To support its conclusion, the Court relied on the following subsection of I.C. § 63-3022 which provided for an adjustment to state taxable income:

In the case of natural persons, there shall be allowed as deductions from gross income either of the following at the option of the taxpayer: (1) the standard deduction as defined by section 63 Internal Revenue Code, or (2) itemized deductions as defined in sections 163, 164 ... Internal Revenue Code.

I.C. § 63-3022(1) (1980) (emphasis added).

In *Bogner*, the Court pointed out that "Section 164 of the Internal Revenue Code specifically *defines* foreign income taxes as an allowable deduction." 107 Idaho at 856, 693 P.2d at 1058 (footnote omitted) (emphasis added). The Court then concluded:

Thus, it is clear that an Idaho resident on his or her state income tax form can deduct from taxable income itemized deductions as *defined* by various sections of the Internal Revenue Code, including § 164, regardless of whether they choose to do so on their federal returns.

Id. (emphasis added).

In *Bogner*, the Court found I.C. § 63-3022(1) to be dispositive because it referred to "itemized deductions as defined" in various sections of the Internal Revenue Code, without requiring that the deductions be "allowed" as provided in I.R.C. § 63. In the present case, there is no subsection of I.C. § 63-3022 comparable to I.C. § 63-3022(1) that would allow Potlatch and ESI to adjust their federal taxable income defined in I.R.C. 63 by deducting the ESOP contributions and R & D expenses which were not allowed by Chapter 1 of the Internal Revenue Code.

III. CONCLUSION

We reverse the district court's judgments and affirm the Commission's denial of the deductions.

Potlatch Corporation v. Idaho State Tax Commission, 128 Idaho 387, 388-390; 913 P.2d 1157, 1158 – 1160 (1996).

In this case, as in the Potlatch case, the petitioner is seeking a deduction not provided for in the Idaho income tax act even though there is a federal provision (Internal Revenue Code

§ 469) from which one might design such a deduction. The treatment for federal purposes generally allows passive losses only to the extent of passive income. If the taxpayer has insufficient passive income to allow the taxpayer to deduct the passive losses, then the loss is deductible in the year in which the taxpayer disposes of the activity.

The Commission finds that the result must follow the Potlatch decision. Therefore, the auditor's adjustment regarding this issue must be affirmed.

The second issue is to what extent the petitioners are entitled to the Idaho capital gains deduction. Idaho Code § 63-3022H stated, in part:

Deduction of capital gains. (1) If an individual taxpayer reports a net capital gain in determining taxable income, sixty percent (60%) of the net capital gain from the sale or exchange of qualified property shall be a deduction in determining taxable income.

(2) The deduction provided in this section is limited to the amount of the net capital gain from all property included in federal taxable income. Net capital gains treated as ordinary income by the internal revenue code do not qualify for the deduction allowed in this section. The deduction otherwise allowable under this section shall be reduced by the amount of any federal capital gains deduction relating to such property, but not below zero. (Underlining added.)

On the petitioners' federal return, the income from the sale of property used in a trade or business held more than one year was treated as ordinary income pursuant to Internal Revenue Code § 1231(c) to the extent of \$128,564. Internal Revenue Code § 1231(c) stated, "(1) In General. The net section 1231 gain from any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses." Idaho Code § 63-3022H stated, in part: "Net capital gains treated as ordinary income by the internal revenue code do not qualify for the deduction allowed in this section." Following this language, the auditor disallowed a portion of the Idaho capital gains deduction claimed by the petitioners.

The capital gain here in question is treated as ordinary income for federal purposes due to losses previously recognized which had nothing to do with Idaho. The petitioners contend that

such losses should not change the character of the gain for purposes of the Idaho capital gains deduction. Therefore, they contend that they should be allowed the capital gains deduction on the entire amount in question.

While one might empathize with the petitioners' argument, the Commission finds the statute to be quite clear. The petitioner reported income from the sale of property used in a trade or business held more than one year in 1997 in the amount of \$166,698. Of this amount \$159,264 was attributable to sales of Idaho property. The income in question (\$166,698) was treated as ordinary income for federal purposes to the extent of \$128,564. Since 95.54% ($\$159,264 / \$166,698$) of the capital gain was from Idaho sources, \$122,830 (95.54% of the \$128,564) was properly treated as ordinary income for Idaho income tax purposes. Therefore, that portion of the gain is not eligible for the Idaho capital gains deduction.

The petitioners speak of two limitations set out in Idaho Code § 63-3022H(2) and believe that they comply with these limitations and, therefore, qualify for the entire capital gains deduction claimed. They state that Idaho Code § 63-3022H(2) limits the deduction to no more than that allowed based on the federal capital gains reported (from all qualified and nonqualified property). The Commission agrees that the petitioners' federal capital gains clearly exceed the Idaho capital gains deduction claimed (\$159,264). The petitioners further contend that three different provisions in the Idaho Rules support their position (Rule 170.01, 170.03b, and 173.03). Rule 173.03 pertained only to multistate entities and, therefore, is inapposite.

Rule §§170.01 and 170.03b stated:

Losses From Nonqualified Property. Losses from property not qualifying for the Idaho capital gains deduction will not reduce the amount of the deduction, unless the Idaho capital gains deduction would otherwise exceed net capital gain included in Idaho taxable income. See Subsection 170.03 for an explanation of the net capital gain limitation.

* * *

Example. A taxpayer recognizes a capital gain of five thousand dollars (\$5,000) on the sale of Idaho real property held more than five (5) years. The taxpayer also recognizes a capital loss of two thousand five hundred dollars (\$2,500) from the sale of shares of stock. These are the only sales during the taxable year. Sixty percent (60%) of the net capital gain from qualified property is greater than the net capital gain included in the taxpayer's taxable income. Therefore, the taxpayer's Idaho capital gains deduction is limited to the net capital gain included in taxable income of two thousand five hundred dollars (\$2,500), not sixty percent (60%) of the net capital gain from the qualified property.

To the extent of the limitations discussed by the petitioners, the analysis seems correct. However, the other limitation set out in Idaho Code § 63-3022H(2) states that, "[n]et capital gains treated as ordinary income by the internal revenue code do not qualify for the deduction allowed in this section." This limitation was not discussed by the petitioners. No explanation was offered as to why this limitation is inapplicable. The Commission finds that this provision is controlling in this case. Even if the provisions in the Rules support the petitioners' position, the provision in the Code precludes the deduction. A regulation (or rule) is ineffective to the extent it is inconsistent with the statute it purports to interpret. K Mart Corporation v. Idaho State Tax Commission, 111 Idaho 719, 727 P.2d 1147 (1986).

WHEREFORE, the Notice of Deficiency Determination dated October 13, 2000, is MODIFIED and, as so modified, is hereby APPROVED, AFFIRMED, AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that petitioners pay the following tax and interest (calculated to December 15, 2001):

YEAR	TAX	INTEREST	TOTAL
1996	\$ 0	\$ 0	\$ 0
1997	4,031	1,144	<u>5,175</u>
		TOTAL DUE	<u>\$5,175</u>

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

An explanation of the petitioners' right 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] Receipt No. [Redacted]
[Redacted]
[Redacted]

ADMINISTRATIVE ASSISTANT 1