BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 15379
[Redacted],	)	
	)	DECISION
Petitioners.	)	
	)	

[Redacted] (Petitioners) protest the Notice of Deficiency Determination issued by the Idaho State Tax Commission (Commission) dated January 19, 2001 asserting additional income tax, penalty, and interest in the total amount of and $5,332 for 1997; and adjusting the 1996 Idaho taxable income of the petitioners without producing an additional liability for the petitioners.

There is only one issue to be addressed in this decision. This is whether passive losses properly allowable for federal purposes in prior years should be allowed in a year of disposition of the activity for Idaho purposes. The portion of the standard deduction 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. The information in the file is not sufficient to establish the date on which they acquired this interest. 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 net gain from the operation of entities operating in Idaho in the amount of $6,909. However, on their Idaho return, they reflected losses of $124,023 without explanation regarding the source of the additional $130,932 of losses. The auditor allowed only a net operating loss carryforward in the amount of $10,241 leaving $120,691 in dispute.

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 <u>to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in the Idaho law</u>; 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 ($120,691) 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 deduction 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).

The Commission finds that, if a nonresident has only activities in Idaho which produce losses in some year, this would often produce a net operating loss. This appears, from the information in the file, to be the case for the petitioners for several years before 1997. Rather than the net operating loss which is provided for in Idaho Code §§ 63-3021 and 63-3022, the petitioners' representative contends that a passive loss carryforward should be allowed which is allowed in a different year than the federal passive loss. The difference would be that the petitioners' contrived Idaho passive loss carryforward should have no limitation on the time in which it could be carried forward. In the petitioners' particular case, this would be more beneficial than the net operating loss prescribed in the Idaho Code. However, in other cases taxpayers might find the net operating loss treatment provided for in the Idaho Code more beneficial since a net operating loss may be carried back. It isn't clear from the petitioners' contentions whether they feel that the net operating loss provisions of the Idaho Code should be considered to be a nullity or whether a net operating loss should be valid until the statute of

limitations was to expire on the net operating loss and then such loss should be somehow converted to the contrived Idaho passive loss carryforward.

Nothing in the Idaho income tax act speaks of a passive loss. There is no specification for how a deduction for an Idaho passive loss should be computed. There is nothing to indicate how it should be applied. Should there be a provision to allow such loss to be carried back? Should it only be carried forward? How far should it be allowed to be carried forward or back? Should it be reduced by other items in the computation of Idaho taxable income (e.g. deductions and exemptions)? These are all unanswered questions relating to the petitioners' proposed deduction.

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 afford 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.

WHEREFORE, the Notice of Deficiency Determination dated January 19, 2001, is MODIFIED and, as so modified, is hereby APPROVED, AFFIRMED, AND MADE FINAL.

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

YEAR	TAX	INTEREST	TOTAL
1996	$ 0	$ 0	$ 0
1997	4,418	1,253	5,671
		TOTAL DUE	$5,671

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