

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
) DOCKET NO. 15333
[Redacted],)
) DECISION
)
Petitioner.)
_____)

On October 13, 2000, the Income Tax Audit Division of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to [Redacted] (taxpayer), disallowing a portion of a tax refund claimed by the taxpayer for the 1993 through 1995 taxable years and asserting a tax deficiency for the 1996 and 1997 taxable years. On December 14, 2000, the taxpayer filed a timely appeal and petition for redetermination. An informal conference was held via telephone on January 22, 2002. The Tax Commission having reviewed the file, hereby issues its decision.

FACTS AND PROCEDURAL HISTORY

During 1993 through 1997 Mr. [Redacted], along with his brother, owned a number of subchapter S corporations that operated “[Redacted]” sporting goods stores throughout the northwest. Each of the [Redacted] Sports retail outlets was set up as a separate S corporation. In 1996 there were approximately 20 retail outlets operating in Oregon, Washington, Idaho, Utah, and Colorado. In addition to the subchapter S corporations that were set up to operate the various retail outlets, [Redacted] and his brother were also the majority shareholders in [Redacted], [Redacted], and one or two other S corporations that held assets or provided some other type of support to the [Redacted] retail outlets. During 1996 and 1997, seven of the [Redacted] S corporations conducted business in Idaho. As a result, [Redacted], who is a resident of Utah, was required to report the Idaho source pass-through income or loss from these

businesses on his 1996 and 1997 Idaho nonresident individual income tax returns. See Idaho Code § 63-3026A(3)(a)(i) and Income Tax Administrative Rule 263 (setting forth the method for determining the amount of pass-through items from a subchapter S corporation that will be considered Idaho source income of a nonresident shareholder).

The [Redacted] retail businesses ran into some rough financial time in 1996 and 1997, which eventually led to an involuntary bankruptcy proceeding in 1998. Many of the various S corporations had losses in 1996 and 1997 that were passed through to the shareholders. In order to achieve the maximum tax benefit, the taxpayer filed amended Idaho income tax returns for 1993, 1994, and 1995 to carryback the losses to the extent they related to the Idaho business operations of the various S corporations. Those amended returns, along with the taxpayer's 1996 and 1997 Idaho individual income tax returns, were selected for audit by the Tax Commission's Income Tax Audit Division. As a result of the audit, the net operating losses claimed on the taxpayer's 1996 and 1997 Idaho nonresident returns were recalculated to apply the Internal Revenue Code § 1366(d)(1) loss limitation. Under that section of the Internal Revenue Code, a loss incurred by an S corporation and passed through to a shareholder may not exceed the shareholder's basis in the stock. In other words, the shareholder is allowed to use the passed-through loss only up to the amount of the basis he has in the S corporation. Any loss that the shareholder is unable to use (because he has no current basis in the corporation) is suspended until he acquires additional basis in the corporation. See I.R.C. § 1366(d)(2).

Before issuing the Notice of Deficiency Determination, that is the subject matter of this administrative protest, the Tax Commission's auditor asked the taxpayer to provide a number of documents to verify his basis in each of the [Redacted] subchapter S corporations. The taxpayer was unable to come up with much of the documentation that was requested. As a result, the

taxpayer's basis in each of the S corporations was determined by the auditor on the information that was available. The I.R.C. § 1366(d)(1) loss limitation was then applied. This resulted in the net ordinary loss claimed by Mr. [Redacted] on his 1996 and 1997 Idaho nonresident individual income tax returns being reduced significantly.

OPINION

A "small business corporation" that elects to be treated as an S corporation under subchapter S of the Internal Revenue Code is normally not subject to federal or Idaho income tax. See I.R.C. § 1363(a). Instead, the income, losses, and deductions of the S corporation are passed through to the shareholders and are to be included on the shareholders' individual income tax returns. I.R.C. § 1366(a)(1). In other words, each shareholder is responsible for reporting his pro rata share of the S corporation's income, losses, and deductions on his individual income tax return. However, Internal Revenue Code § 1366(d)(1) creates a "special rule" that limits the amount of pass-through losses and deductions that a shareholder is allowed. Under section 1366(d)(1), a shareholder is only entitled to claim pass-through losses and deductions to the extent that those losses or deductions do not exceed the sum of the shareholder's adjusted basis in the corporation's stock and any indebtedness of the corporation that is owed to that shareholder.

The taxpayer does not take issue with the Internal Revenue Code § 1366(d) loss limitation. Rather, he claims that he has additional basis in many of the [Redacted] S corporations that the auditor simply did not give him credit for. The taxpayer further asserts that the reason he is unable to provide the auditor with most of the verification that was requested is because many of the books and records of the various [Redacted] S corporations were subpoenaed by the U.S. Bankruptcy Trustee when the companies were

forced into bankruptcy in 1998. These records, according to the taxpayer, were then lost or destroyed while in the possession of the Trustee. Apparently, no copies of any of these records were kept by the taxpayer or by his accountant. In any event, the taxpayer contends that if he had access to the records provided to the Bankruptcy Trustee he would be able to substantiate some additional basis in many of the various Pedersen Sports S corporations.

In addition to the lack of documentation resulting from the delivery of the [Redacted] business records to the Bankruptcy Trustee, the taxpayer also argues that the auditor made an arbitrary allocation of basis related to the purchase of shares from his father's estate. In late 1995, [Redacted] and his brother paid \$466,000 to purchase from their father's estate all of the shares of nine [Redacted] S corporations, including shares of [Redacted], that were owned by their father at the time of his death. In the agreement between the brothers and the estate, there was no specific allocation of the purchase price to the stock of the nine corporations. On audit, the Commission's auditor determined that one-half of the purchase price should be allocated to the [Redacted] stock, and that the remaining one-half of the purchase price should be allocated among the other eight S corporations in proportion to their respective capital account balances as of January 1, 1996. Mr. [Redacted] argues that auditor's allocation was arbitrary and that all of the purchase price should be allocated to the [Redacted] stock. By allocating 100% of the purchase price to the [Redacted] stock (as opposed to the 50% allocated by the Commission's auditor), the adjusted basis of that stock would be increased and more of the otherwise suspended net operating loss from that corporation would be available to the taxpayer.

It is well established that the taxpayer bears the burden of proof regarding his adjusted basis in property. Burnet v. Houston, 283 U.S. 223, 51 S.Ct. 413 (1931). See also Faust v. C.I.R., T.C. Memo 1995-481, 70 T.C.M. (CCH) 928 (1995) (Taxpayer's failure to substantiate

his basis in stock of an S corporation as required by I.R.C. § 1366(d)(1) resulted in the disallowance of the loss claimed by the taxpayer.). Burnet v. Houston involved a taxpayer (Houston) who paid \$305,000 in 1906 for a one-eighth interest in a corporate reorganization plan. In 1920, after the reorganization plan failed to achieve the results anticipated by the investors, the taxpayer received \$33,300 in complete liquidation of the corporation. On his 1920 federal income tax return, the taxpayer then claimed a loss of \$271,700 (\$33,300 proceeds less \$305,000 cost basis) relating to the liquidation. However, a specific provision of the federal income tax laws created a limitation to the amount of gain or loss that could be claimed on the sale or disposition of property acquired prior to March 1, 1913. With respect to such property, the basis of the property for purposes of determining the allowable gain or loss was the lesser of the cost basis of the property or its fair market value as of March 1, 1913. Thus, if the March 1, 1913, fair market value of the property was lower than the cost basis, the March 1, 1913, fair market value was to be used to determine the amount of gain or loss that could be claimed.

On audit, the Internal Revenue Service disallowed the \$271,700 loss claimed by the taxpayer on his 1920 return because there had been no showing that the correct basis was used in computing the loss. According to the Service, since the taxpayer has not provided any evidence of the fair market value of the investment as of March 1, 1913, no loss could be allowed. The Third Circuit Court of Appeals disagreed and reinstated the \$271,700 loss. According to the Court of Appeals, determining a true or approximate value of the investment as of March 1, 1913, “was a sheer impossibility.” As a result, using the cost basis of the investment (as opposed to the 3/1/1913 fair market value) was appropriate. The case was then appealed to the United States Supreme Court.

On appeal, the Supreme Court reversed the Third Circuit Court of Appeals. According to the Supreme Court:

The burden of proof to establish a deductible loss and the amount of it, clearly, was upon the [taxpayer]. It was just as necessary under the statute for the [taxpayer] to prove value as of March 1, 1913, as it was to prove cost in 1906 and the amount finally received by him in 1920. . . .

We cannot agree that the impossibility of establishing a specific fact, made essential by the statute as a prerequisite to the allowance of a loss, justifies a decision for the taxpayer based upon a consideration only of the remaining factors which the statute contemplates. The definite requirement of section 202(a)(1) of the act is not thus easily to be put aside. The impossibility of proving a material fact upon which the right to relief depends simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof.

Id. at 227-228, 51 S.Ct. at 415 (citations omitted). The Supreme Court then went on to emphasize that the taxpayer, at the very least, had to make some reasonable effort to determine the approximate market value of the investment as of the date required under the statute. Having made no effort, and relying solely on the claim of impossibility, the taxpayer simply had not met the burden of proof required for claiming a loss on the liquidation of his investment. As succinctly stated by the Supreme Court, the taxpayer “was bound to produce the best available evidence of value which the circumstances and nature of the transaction permitted. It does not appear that he made any attempt to do so.” Id. at 229, 51 S.Ct. at 415. As a result, no loss was allowed.

Burnet v. Houston is instructive for at least two reasons. First, the U.S. Supreme Court clearly establishes that the burden is on the taxpayer to prove the amount of a deductible loss. Inherent in this duty is the burden of establishing the basis of the property that is the subject matter of the claimed loss. Where a taxpayer is unable to provide sufficient evidence to establish

the basis of the property giving rise to the loss, no basis will be allowed or will only be allowed to the extent actually established by the facts available to the taxing authority.

The second interesting point to be gleaned from the Burnet v. Houston case is that even where books and records detailing the basis of property are not available, the taxpayer is still duty bound to “produce the best available evidence . . . which the circumstances and the nature of the transaction” will permit. In other words, even where the books and records that would normally be relied upon to substantiate the basis in property are lost or mislaid, the taxpayer must make reasonable efforts to reconstruct the basis of his property based on what information is available. Simply relying on the fact that the normally relied on records are unavailable is not sufficient to meet the taxpayer’s burden of proof.

In the present case, the Tax Commission finds that the auditor correctly determined the basis of the [Redacted] S corporation stock based on the information that was made available to him. The fact that much of the information normally relied on to substantiate the basis of the S corporation stock may have been lost or mislaid by the U.S. Bankruptcy Trustee does not convince us that the basis as calculated by the auditor should be disregarded. On the contrary, the taxpayer has the obligation to provide the best possible reconstruction of the basis as the circumstances would permit. Over a year and a half has passed since the taxpayer filed his letter of protest with the Tax Commission. In that time he has not provided any additional evidence or documentation to support the claim that the basis of the S corporations should be increased from the amount determined by the auditor. This is so even though the Tax Commission, on January 23, 2002, the day after the telephone informal conference, made a specific request for certain documents and records that might have been useful in determining whether any additional basis

should be allowed. See letter dated January 23, 2002, from [Redacted] to [Redacted]. The Commission received no response to its request.

Obviously, the taxpayer has been put into a tough spot as a result of the apparent loss or destruction of the [Redacted] business records by the U.S. Bankruptcy Trustee. How these records were lost, or why the taxpayer or his accountant kept no copies of the materials turned over to the Trustee, remains a mystery. But in any event, given that the taxpayer clearly has the burden of proving that the basis calculation made by the Tax Commission's audit staff is incorrect, no additional basis can be allowed.

In addition, the Tax Commission is not convinced that it would be more reasonable to allocate 100% of the purchase price paid in 1995 to acquire Mr. [Redacted] father's stock in nine (9) [Redacted] S corporations to only one of those S corporation. Presumably all nine of those S corporations had some value at the time they were acquired. While the Commission has no doubt that the [Redacted] stock may have been the most valuable, there is no evidence to suggest that the stock of the other eight corporations was worthless or of a purely inconsequential value. There are certainly other allocation methods that could have been employed by the audit staff. However, the taxpayer's claim that all of the purchase price should be allocated to the [Redacted], Inc. stock is simply not reasonable.

ORDER

WHEREFORE, the Notice of Deficiency Determination dated October 13, 2000, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer receive a refund as follows:

<u>YEAR</u>	<u>REFUND ALLOWED</u>	<u>ADDITIONAL TAX DUE</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1993	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
1994	(7,243)	0	0	(2,495)	(9,738)
1995	0	0	0	0	0
1996	0	4,406	1,102	1,799	7,307
1997	0	10	10	4	<u>24</u>
			NET AMOUNT TO BE REFUNDED		<u>(\$2,407)</u>

Interest is calculated through June 30, 2002.

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2002.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2002, 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