

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 16698
[Redacted],)	
)	DECISION
Petitioners.)	
_____)	

On June 21, 2002, the Income Tax Audit Bureau (Bureau) of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (petitioners) concerning the taxable years 1999 and 2000. The notice advised the petitioners of their right to file a petition for redetermination with the Commission if they disagreed with the Bureau's determination.

The petitioners submitted a written protest on June 27, 2002. The Commission treated the protest as a petition for redetermination. The petitioners also submitted amended returns and other information in support of their petition. The petitioners requested an informal conference, which was held at the offices of the Tax Commission on September 17, 2002. [Redacted] appeared at the conference. [Redacted] discussed his reasons for seeking a redetermination and submitted additional information during the conference. At the conclusion of the conference, the matter was considered fully submitted.

This decision is based on the information contained in the Commission's file, including materials submitted before and during the informal conference. The Commission has reviewed the file, is advised of its contents, and now issues this decision. For the reasons set forth below, the Commission affirms the deficiency determined by the Bureau with the exception of modifying the taxable year 2000 tax liability to address an error the petitioners made when reporting withdrawals from an Individual Retirement Account.

The petitioners reside in [Redacted]. For the taxable years 1999 and 2000, they prepared and filed federal and Idaho individual income tax returns. The petitioners organized the

[Redacted], from which they receive income on an annual basis. The petitioners also hold several stocks and bonds. Some of the bonds are out-of-state municipal bonds.

An auditor of the Tax Commission's Audit Bureau examined the returns filed by the petitioners and made several adjustments to the returns. A majority of the auditor's adjustments concerned income and expenses that flowed through from the trust to the petitioners. For instance the petitioners reported less dividend income from the trust than the amount of dividend income reported by the trustee. A similar apparent under-reporting occurred in regard to capital gains passed through by the trust. The auditor determined the petitioners did not report the interest income the trust received on certain municipal bonds. The auditor concluded that under Idaho Code § 63-3022M and IDAPA 35.01.01.115, the interest income should be included in the income the petitioners report for Idaho individual income tax purposes. In general terms, the auditor also adjusted the petitioners' treatment of trust fees, capital gain income and itemized deductions.

ISSUES

The petitioners raised several issues in their written protest and during the informal conference. Many of the issues the petitioners raised in the present protest were raised and addressed in previous appeals. Such issues include:

1. Interest income from investments in municipalities should be tax-exempt.
2. Dividend income earned on non-Idaho municipal obligations is subject to tax by the non-Idaho state and not by the state of Idaho.
3. Trust fees should be considered a reduction in capital and deductible on federal schedule D as additional stock basis.
4. A portion of the dividends received on investments held in public utilities is exempt from federal and state taxation because the dividends simply are returns of capital.

The petitioners raised these same issues in a previous tax appeal docketed by the Tax Commission as Docket No. 12994. Docket No. 12994 concerned the petitioners' deficiency for tax years 1995 and 1996. The Commission's decision in Docket No. 12994 rejected the petitioners' arguments and upheld the auditor's adjustments.

The petitioners appealed the Commission's decision in Docket No. 12994 to the Idaho Board of Tax Appeals. The Board rejected the petitioners' arguments and affirmed the Commission's decision. *See Idaho Board of Tax Appeals Decision in Appeal No. 99-B-829* (October 1, 1999). The petitioners did not appeal the Board's decision.

Because both the Board of Tax Appeals and the Commission addressed the above-identified issues in previous decisions, the Commission will not address those same issues again in this decision. Instead, the Commission simply adopts, and incorporates herein by reference, its previous decision in Docket No. 12994 (attached as addendum).

The petitioners have raised other issues in this case which the Board of Tax Appeals has not addressed in a previous decision. The petitioners assert that:

5. The Tax Commission cannot rely on documentation dated outside the statute of limitations when issuing a Notice of Deficiency Determination.
6. The audits that led to the Notice of Deficiency Determination in this matter were not really audits; they were simply a paper correction of the taxpayers' returns.
7. The auditor improperly disallowed capital losses carried forward from previous years.
8. Trust fees and certain other expenses should be deducted as business expenses on schedule C.
9. The petitioners' repair of a geothermal energy line at their residence should qualify for the alternative energy deduction provided in Idaho Code § 63-3022C.
10. An adjustment to the petitioners' adjusted gross income and 2% limitation on itemized deductions for the taxable year 1999 should be made because the Internal Revenue Service made an adjustment to the petitioners' taxable social security for federal income tax purposes.

11. In determining the petitioner's deficiency, the Tax Commission's auditor failed to apply a \$4,000 "estimated" payment the petitioners made with respect to the taxable year 1999.
12. The petitioners mistakenly reported their IRA withdrawals for taxable year 2000 as \$4,000 rather than \$3,000. Therefore the adjusted gross income the petitioners reported on their 2000 tax return should be reduced resulting in a decreased tax obligation for that year.

DISCUSSION

1-4. FOR A DISCUSSION REGARDING ISSUES 1 THROUGH 4, SEE THE COMMISSION'S DECISION IN DOCKET NO. 12994, ATTACHED HERETO AS AN ADDENDUM.

5. THE STATUTE OF LIMITATIONS

Idaho Code § 63-3068 limits the time in which the Commission may issue a Notice of Deficiency Determination. The statute provides in part:

63-3068. Period of limitations for issuing a notice of deficiency and collection of tax. -- (a) Except as otherwise provided in this section, a notice of deficiency, as provided in section 63-3045, Idaho Code, for the tax imposed in this chapter shall be issued within three (3) years from either the due date of the return, without regard to extensions, or from the date the return was filed, whichever is later.

This time restriction for issuing a Notice of Deficiency Determination is often referred to as "the statute of limitations."

The petitioners contend that since they paid their 1999 taxes on December 31, 1999, the three-year period of limitations will expire on December 31, 2002. Similarly, the petitioners maintain they paid their 2000 taxes on December 31, 2002 and therefore the statutory period will expire on December 31, 2003.

It is difficult to understand the petitioners' argument in this respect. To begin with, the petitioners err in their interpretation of the statute. The three-year limitation does not begin to run with the payment of taxes. The statute provides that the time for issuing a Notice of Deficiency

Determination expires three years from the date a return is filed, or from the due date of the return, whichever is later. In this case, the limitation began to run on the due dates of the returns, April 15, 2000 and April 15, 2001, respectively. The time for issuing a Notice of Deficiency Determination for each of the tax years at issue would be April 15, 2003 and April 15, 2004.

However, even under the petitioners' interpretation, the statute of limitations had not expired when the auditor issued the Notice of Deficiency Determination in this matter. The auditor issued the Notice of Deficiency Determination on June 21, 2002, a date well in advance of the December 31, 2002 and December 31, 2003 dates argued by the petitioners.

The petitioners also stated the auditor relied upon information, including certain records regarding stock ownership and sales, that were created more than three years ago. Although not entirely clear, it appears the petitioners believe the auditor was barred from relying upon any records more than three-years old when determining the petitioners' income and expenses for the years at issue.

The statute imposes a restriction on when the Commission may issue a Notice of Deficiency Determination; however, the statute does not impose any limitation on the type or age of information the Commission may examine when determining the proper amount of tax a person is obligated to pay. In this case the petitioners have declined to provide certain information, such as reports from the trustee [Redacted], claiming it is confidential or "private" information. When a person withholds necessary information, the Commission is relegated to use the best available information to determine the person's tax obligation. Sometimes the best available information consists of reports and records (perhaps tax returns and the documentation attached to tax returns) created or filed in past years.

Under the petitioners' theory, the Commission would be barred from considering such information. Instead, the Commission would be forced to guess blindly at the amount of taxes owed by persons who refused to provide necessary information or to file returns. For obvious reasons, administration of the Idaho individual income tax based on such a system of estimation is not desirable for either the state of Idaho or for taxpayers.

6. EXAMINATIONS AND CORRECTION OF TAX RETURNS

The petitioners state that the Notice of Deficiency Determination is not valid because the auditor did not really perform an "audit." The petitioners contend the auditor was required to visit their home and the bank (trustee) to review all records necessary to determine a correct tax obligation. The petitioners argue that absent the Commission conducting an "on-site audit" or "field audit" to discover the necessary information, the Notice of Deficiency Determination must be disregarded.

Idaho Code § 63-3040 requires the Commission to examine all returns and determine the correct amount of tax for each return. Idaho law does not require a field audit before the Commission may make necessary adjustments to a filed return. Such a requirement would require state auditors to spend countless hours auditing each taxpayer and would be prohibitively expensive for the people of Idaho.

In the event the Commission finds a return to be deficient, Idaho Code § 63-3045 directs the Commission to issue a Notice of Deficiency Determination. A Notice of Deficiency Determination is not a tax assessment. A deficiency determination does not become an assessment until a taxpayer has been afforded all of his or her appeal rights. Idaho Code § 63-3044(2). A person may supply the Commission with information to correct a potentially erroneous deficiency determination at any time before the determination becomes an assessment.

7. *PETITIONERS' CLAIM TO A CAPITAL LOSS CARRYOVER*

In the Commission's previous decision (Docket No. 12994), a capital loss carryover for tax year 1996 was disallowed based on adjustments made to the petitioners' 1995 tax return. The petitioners claimed more than \$18,000 in losses but could only substantiate \$900 at the informal conference. Under the Commission's previous decision, as affirmed by the Idaho Board of Tax Appeals, the petitioners were not entitled to the loss they claimed. The petitioners cannot now attempt to carry forward the disallowed loss to the taxable years at issue.

8. *DEDUCTIBILITY OF CERTAIN TRUST AND OFFICE EXPENSES*

The petitioners, in arriving at federal adjusted gross income, subtracted trust fees and similar expenses. The petitioners maintain they should be allowed to fully deduct the trust fees and expenses on Schedule C as business expenses. However, the trust expenses that flowed through to the petitioners are not expenses the petitioners occurred in an operation of a business. It could be argued that the expenses, such as expenses associated with Internet services the petitioners receive at their residence, are personal expenses and are not deductible.

Alternatively, some of the expenses could be considered investment expenses. Under Internal Revenue Code Section 212 (Section 212), investment expenses are deductible as itemized expenses on Schedule A. Section 212 allows a deduction for ordinary and necessary expenses paid or incurred (1) for the production or collection of income; (2) for the management, conservation, or maintenance of income-producing property; or (3) in connection with the determination, collection or refund of any tax. Treasury Regulation § 1.212-1(g) treats custodial fees or similar expenses as deductions falling under Section 212 to the extent they meet certain criteria. Treasury Regulation § 1.212-1(g) reads as follows (emphasis added):

Fees for services of investment counsel, **custodial fees**, clerical help, office rent, and **similar expenses** paid or incurred by a taxpayer in connection

with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

In contrast to Schedule C deductions, the itemized investment expenses on Schedule A would not be fully deductible as a Schedule C expense. Section 212 deductions are not deductions in arriving at adjusted gross income. IRC § 62. The deductions are treated as itemized deductions deductible from adjusted gross income. IRC § 63(d). Section 212 deductions are generally subject to the two-percent floor on miscellaneous itemized deductions. IRC § 67.

The auditor determined that the petitioners were eligible to deduct trust fees and other investment expenses under Internal Revenue Code § 212 (Section 212). The auditor then considered the effect of itemizing the claimed deductions on Schedule A and determined that taking a standard deduction rather than itemizing deductions would advantage the petitioners. Based on this information, it appears the auditor gave the petitioners the benefit of any doubt and treated the claimed deductions appropriately.

In addition to expenses associated with personal Internet services, the petitioners asked that certain damages to a musical instrument be deducted as a business expense. The petitioners ordered an organ from an instrument company located in the state of [Redacted]. Apparently the organ was severely damaged during shipment to [Redacted]. The petitioners stated they purchased the organ for \$7,810 and paid freight in the amount of \$320, therefore they estimate their loss to be \$8,130. However, the petitioners have not demonstrated that these expenses were, as required by IRC § 212: (1) for the production or collection of income; (2) for the management, conservation, or maintenance of income-producing property; or (3) in connection

with the determination, collection or refund of any tax. These expenses appear to be nondeductible personal expenses rather than expenses related to a business.

9. *THE DEDUCTION FOR AN ALTERNATIVE ENERGY DEVICE*

The petitioners maintain that repair of the geothermal energy line used to heat their house should qualify for the alternative energy deduction. The Idaho Legislature provided a deduction for certain alternative energy devices.

63-3022C. DEDUCTION FOR ALTERNATIVE ENERGY DEVICE AT RESIDENCE. (1) An individual taxpayer who installs an alternative energy device to serve a place of residence of the individual taxpayer in the state of Idaho may deduct from taxable income the following amounts actually paid or accrued by the individual taxpayer: forty percent (40%) of the amount that is properly attributable to the construction, reconstruction, remodeling, installation or acquisition of the alternative energy device in the year when such device is completed or acquired and is placed in service by the taxpayer; and twenty percent (20%) per year thereafter for a period of three (3) succeeding years; provided, however, that said deduction shall not exceed five thousand dollars (\$5,000) in any one (1) taxable year.

* * * *

(3) As used in this section, "alternative energy device" means any system or mechanism or series of mechanisms using solar radiation, wind or geothermal resource as defined in section 42-4002, Idaho Code, primarily to provide heating, to provide cooling, to produce electrical power, or any combination thereof. . . .

Idaho Code 63-3022C (1998). The petitioners have had the geothermal device at their home for several years, but recently made repairs to the line that transmits geothermal energy to their house.

The auditor disallowed the deduction claimed by the petitioners. The auditor determined the deduction pertained to placing an alternative energy device into service for the first time. The auditor did not believe the statute provided a deduction for repairs made to an existing alternative energy device that had already been used for several years by the taxpayer.

A review of the statute under the applicable rules of statutory interpretation shows the auditor correctly interpreted that statute. A fundamental rule of statutory construction is that statutes must be interpreted based on the plain meaning of words contained in the statute: the plain meaning of a statute cannot be altered by adding language that does not exist in the statute or by ignoring language in the statute. George W. Watkins Family v. Messenger, 118 Idaho 537, 797 P.2d 1385 (1990); Marmon v. Marmon, 121 Idaho 480, 825 P.2d 1136 (1992). The plain language of Idaho Code § 63-3022C provides a deduction for the first four years an alternative energy device is completed and placed into service. The statute does not provide a deduction for repairs to an alternative energy device completed and placed into service by a taxpayer several years ago.

The petitioners argued that the statute does not address repairs and therefore is ambiguous at best. The petitioners asserted that such an ambiguity should be interpreted in their favor. The Commission does not find the statute to be ambiguous; however, for the sake of discussion, even assuming Idaho Code § 63-3022C contained an ambiguity concerning repairs made to an existing alternative energy device, a deduction still would not be appropriate. While ambiguities in statutes that impose general tax obligations and duties generally are construed in favor of the taxpayer, an opposite result occurs when an ambiguity exists in a statute providing a tax deduction or exemption. If there is any ambiguity in the law concerning tax deductions, the law is to be construed strictly against the taxpayer and in favor of the state's taxing authority. Hecla Mining Co. v. Idaho Tax Comm'n, 108 Idaho 147, 697 P.2d 1161 (1985); Appeal of Sunny Ridge Manor, Inc., 106 Idaho 98, 675 P.2d 813 (1984); Bistline v. Bassett, 47 Idaho 66, 272 Pac. 696 (1929). This is because taxpayers do not have a constitutional right to tax deductions and exemptions. Deductions and exemptions are created by and exist solely at the

discretion of the legislature. If a statute regarding a deduction or exemption fails to clearly express the legislature's intent in a specific instance, it is presumed the legislature has not granted the deduction. Therefore, if an ambiguity could be said to exist in the statute, the petitioners still would not be entitled to the deduction they now seek.

10. THE FEDERAL ADJUSTMENT TO TAXABLE SOCIAL SECURITY DOES NOT AFFECT THE PETITIONERS' STATE TAXES.

The petitioners submitted documents from the [Redacted] that show the Service adjusted the petitioners' calculation of taxable social security for federal income tax purposes. The petitioners calculated and reported \$17,766 of taxable social security on their federal return. The [Redacted] recalculated the petitioners' taxable social security income as \$12,487 and issued a refund. The petitioners asked the Idaho State Tax Commission to make a similar adjustment for state tax purposes.

Such an adjustment is not necessary because the petitioners already removed all social security income in arriving at Idaho taxable income.

The petitioners reported their federal adjusted gross income, including the \$17,766 of social security income, on line 9 of their 1999 Idaho income tax return. However, on line 22 of the return, under the heading "Subtractions" the petitioners then deducted their social security income, \$17,776 (an error of \$10), in accordance with Idaho Code § 63-3022(1). The result of the calculation was to "zero out" or completely remove the petitioners' social security income from the amount of income subject to Idaho income tax.

Making the adjustment proposed by the petitioners would result in an under-reporting of the petitioners' income. Because social security income is not taxed and is completely removed from a taxpayer's income, the adjustment made for federal tax purposes has no effect on the petitioners' Idaho income tax. Under the adjustment, the petitioners would report approximately

\$5,180 less adjusted gross income, but their deduction for social income would also be \$5,180 less. In short, both before and after the adjustment, the petitioners' social security income and the subsequent social security deduction result in a wash for Idaho income tax purposes.

11. THE \$4,000 ESTIMATED PAYMENT WAS ACCOUNTED FOR AND APPLIED BY THE PETITIONERS ON THEIR 1999 IDAHO TAX RETURN.

On December 29, 1999, the petitioners made an estimated tax payment of \$4,000 regarding their taxable year 1999 taxes. The petitioners later accounted for and applied the estimated payment against their 1999 tax liability on their 1999 Idaho tax return. After calculating the total income tax for the year on line 53 of their return, the petitioners then deducted from the total income tax all previously made payments and applicable credits, including grocery credits. As indicated on line 62 of their return, the petitioners applied the \$4,000 against the total tax calculated. Because the estimated payment exceeded the total tax owed for the year, the petitioners claimed and received a refund for the year in the amount of \$2,793.

The petitioners filed their return on April 15, 2000. The records of the Tax Commission indicate the petitioners cashed their refund check on May 12, 2000.

When the Tax Commission's auditor later examined the petitioner's returns and records, she discovered the errors discussed above and found the petitioners owed additional tax based on those errors. However, the auditor did not change or reverse the estimated payment of \$4,000 the petitioners entered on line 62 of their return. The petitioners received and continue to receive credit for the estimated payment.

12. IT APPEARS THE PETITIONERS ERRED IN REPORTING WITHDRAWALS FROM THEIR INDIVIDUAL RETIREMENT ACCOUNT.

When the petitioners filed their 2000 federal income tax return (Form 1040), they reported withdrawals from an Individual Retirement Account (IRA) on line 15b in the amount of \$4,000. The \$4,000 became part of the petitioners' federal adjusted gross income reported for the taxable year 2000.

Prior to the informal conference conducted in this matter, the petitioners submitted a statement that read: "I made an error in error in reporting IRA withdrawal. A withdrawal of \$4,000 was reported on the 1040. The correct amount I should have reported was \$3,000. This should result in a decrease of 1040 line 31 gross income."

Financial institutions report IRA withdrawals on Form 1099-R. A review of two Forms 1099-R issued by Northeast Management and Research Co., Inc. indicates that during the taxable year 2000 the petitioners made two withdrawals from the IRA managed by the company. The petitioners made withdrawals in the amounts of \$1,200 and \$1,800 respectively. The federal tax information obtained in this matter does not indicate that the petitioners made other withdrawals from the IRA during the taxable year. Therefore it appears that the petitioners over-reported their IRA withdrawals for the year and that their adjusted gross income should be decreased by \$1,000 for taxable year 2000.

CONCLUSION

It is well settled in Idaho that a Notice of Deficiency Determination issued by the Idaho State Tax Commission is presumed to be correct. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814 (1984); Parsons v. Idaho State Tax Commission, 110 Idaho 572, 574-575 n.2 (Ct. App. 1986). The burden is on the petitioner to show that the tax deficiency is erroneous. Id. For the foregoing reasons the Tax Commission finds that, with the exception of the over-

reporting of IRA withdrawals for the taxable year 2000, the petitioners failed to meet the burden in this case.

Therefore, the Notice of Deficiency Determination dated June 21, 2002, is hereby MODIFIED 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>
1999	\$3,087	\$154	\$697	\$3,938
2000	\$3,727	\$186	\$543	<u>\$4,456</u>
				<u>\$8,394</u>

Interest is calculated through January 24, 2003, and thereafter will continue to accrue at the rate of \$1.31 per day during the year 2003 until paid.

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

An explanation of the taxpayers' rights 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] Receipt No. [Redacted]
[REDACTED]
