

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 16129
[Redacted],	)	
	)	DECISION
Petitioners.	)	
_____	)	

On September 28, 2001, the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayers), denying claimed refunds and proposing additional income tax, penalty, and interest for each of the tax years ending 12/31/91 through 12/31/99, inclusive, in the total amount of \$330,543.

On November 26, 2001, a timely protest and petition for redetermination was filed by the taxpayers. An informal conference was requested by the taxpayers and held on April 25, 2002. A second informal conference was held on October 25, 2002.

The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision modifying the Notice of Deficiency Determination.

**Facts**

The taxpayers are a married couple, nonresidents of Idaho. The wife is a party to the protest by virtue of having filed a joint federal income tax return with the husband. The husband is a developer and operator of commercial real estate. His largest holding is a grantor trust (the "Trust").

The Trust owns the following:

- A number of rental properties that generate net losses in the aggregate. In 1991 and 1992, one or more of the Trust's holdings had Idaho property, payroll, and revenues.
- Starting in 1993, a commercial rental property in Idaho, which generated a profit even

after the taxpayers assigned various expenses against the rental income. This property was exchanged to a third party under Internal Revenue Code (IRC) § 1031 for out-of-state property in 1996. Income and expenses attributable to this property continued to show in the taxpayers' books through 1998.

- Starting in 1995, about 20% of a partnership that has property and revenues in Idaho, generating losses, and files an Idaho partnership return.
- Starting in 1998, 100% of a business trust that acquired a retail store in Idaho and generated Idaho losses.
- Interests in other partnerships and limited liability companies (LLCs) that operate entirely outside Idaho. There were about 15 partnerships in 1991; this grew to about 34 by 1999.
- Assets producing interest income. The Trust also makes charitable contributions and incurs investment interest expense.

Idaho returns. The taxpayers filed their 1991 and 1992 Idaho nonresident returns in 1994. Their 1994 through 1999 returns were filed timely. The 1997-1999 original returns used the three-factor method (discussed below) to apportion income of the Trust. In 2000, the taxpayers amended their 1995, 1996 and 1997 returns (but not the 1994 return due to an oversight) to report a carryback of federal net operating losses (NOLs) from 1997; the 1995 return asked for a refund but was filed after the regular statute of limitations had run. The taxpayers request to use the extended statute of limitations applicable to reporting of Idaho net operating loss (NOL) carrybacks to reopen the 1995 year.

In 2001, the taxpayers filed their original 1993 return and the original 1993 Trust return, reporting [Redacted] that are not disputed here and employing the three-factor formula for the

Trust. They also filed unsigned amended individual returns and signed grantor trust returns for 1991, 1992, and 1994-96 to report Trust income on the taxpayers' returns using the three-factor formula.

The taxpayers' desired combined apportionment factor runs about 7%-9% in 1991-95, and much less in 1996-99, dwindling below 1% in 1998. The taxpayers claim a cumulative NOL carryover entering 2000 in the amount of \$604,568.

Audit results. In a desk audit, the auditor denied refunds for 1991, 1992, and 1994-96 because the years were beyond the statute of limitations. The auditor denied use of the three-factor method for 1993, 1997, 1998 and 1999.

The documentation submitted by the taxpayers behind their three-factor returns is voluminous and complex, and has not been audited. The auditor used some of these documents to develop Idaho source income amounts for 1993, 1997, and 1998. Those adjustments are taken from the income statements of the Idaho rental property before it was exchanged; from the K-1s issued by the partnership to the Trust; and from income statements of the business trust.

The audit shows NOL in 1999, of which \$100,000 is carried back to 1996.

A nonfiler penalty of 25% was imposed for 1993. The 1997-1998 penalty was a substantial understatement penalty.

After the first informal conference, the auditor adjusted certain expense items between Idaho sources and non-Idaho sources. The effect was to reduce the tax deficiency, eliminating all deficiencies and penalties for 1997 and 1998.

Protest issues. The main issue in this case is, how much of the Trust's income flows through to the taxpayers' individual returns as Idaho source income. The taxpayers want to use the three-factor formula at the trust level to offset the Idaho commercial rental profits with non-

Idaho losses and then to pass the resulting losses through to the taxpayers as Idaho source losses. If the taxpayers can do this, then even though most of the years were closed to refunds on amended returns, they have no deficiencies and have a large NOL carryover available going into 2000.

The second issue is whether an amended 1995 return reporting a federal (but not Idaho) NOL carryback from 1997 to 1995, which has the effect of changing 1995 federal itemized deductions due to changed adjusted gross income (AGI), can generate an Idaho refund where the 1995 amended return was filed more than three years after the original return was filed but within the extended statute of limitations applicable to amendments carrying back Idaho NOLs.

The penalties are not mentioned in the protest.

### **Law and analysis**

Net operating losses carried from closed years may be adjusted in open years by either the taxpayer or the state.

It is the practice of the Tax Commission to adjust NOL carryovers arising in closed years in computing tax liability in open years. Neither the Idaho Code nor the rules before 1997 specifically state that an NOL carried forward from a closed year can be adjusted in an audit of an open year. But it is well settled in federal income tax law that the IRS and the courts may adjust income and deductions in a closed year to reduce or increase an NOL carried into an open year.<sup>1</sup> The IRS may also adjust the income of a closed year that is used to absorb an NOL. Our decision in

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<sup>1</sup>IRC § 6214(b)(Tax Court can consider facts in years not in litigation); *Phoenix Coal Co. v. Comm'r*, 231 F.2d 420 (2d Cir. 1956); *Springfield St. Ry. Co. v. U.S.*, 312 F.2d 754 (Ct. Cl. 1963); *Forres v. Comm'r*, 25 BTA 154 (prior law); *Hajos v. Comm'r*, TCM 1964-328; *Simon v. Comm'r*, TCM 1960-34; Rev. Rul. 56-285, 56-1 C.B. 134; Rev. Rul. 81-88, 81-1 C.B. 585; Rev. Rul. 85-64, 85-1 C.B. 365.

Docket No. 11418 (1997), and Rule 201.02.b (1997), provide that the Tax Commission may adjust an NOL that is carried forward from a closed year into an open year.

A taxpayer has the right to adjust his or her income or loss in closed years to increase an NOL carryover into an open year. So even though 1991 and some other years here were closed when the taxpayers filed unsigned amended returns using the three-factor method for the Trust and tax refunds for those years were thus barred, the taxpayers are not barred from applying the three-factor method to increase their NOL carryover entering 2000.

A nonresident individual taxpayer may not employ combined reporting to combine his interest in profitable Idaho real property with his interests in unprofitable partnerships outside Idaho

The first question is whether the taxpayers may offset losses from entities operating outside Idaho against their income from the Idaho commercial rental property before that property was exchanged. The answer to this question is no. (The effect of the Trust structure on this question is discussed below.)

In 1991-1995, taxation of nonresident individuals was governed by Idaho Code § 63-3027A. A nonresident individual's taxable income is computed by prorating itemized deductions and personal exemptions in the proportion of Idaho AGI to total AGI<sup>2</sup> from all sources. Idaho AGI is computed by adjusting Idaho source income for deductions related to its production. Idaho Code § 63-3027A (1991-1992). That language was amended in 1992 to provide, "The taxable income of nonresident individuals [and] trusts ... includes only those components of Idaho taxable income as computed for a resident, derived from or related to sources within Idaho." Thus, the taxpayers here are taxable only on Idaho source income, net of related deductions.

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<sup>2</sup> AGI was separately defined with reference to IRC § 62 in new § 63-3011A, added in 1995.

Under § 63-3027A, each business entity in which a nonresident individual owns an interest apportions its income separately between Idaho and other states, and any resulting Idaho income and loss passes through to the Idaho return. Entities with no Idaho presence pass through no Idaho source income or loss (*Preston v. Idaho State Tax Commission*, 131 Idaho 502 (1998)); their aggregate amounts merely affect total income, which in turn affects the Idaho proration of itemized deductions and personal exemptions.

Effective in 1996, Idaho Code § 63-3027A was repealed and replaced by § 63-3026A, which read in part as follows:

**63-3026A. COMPUTING IDAHO TAXABLE INCOME OF PART-YEAR OR NONRESIDENT INDIVIDUALS, TRUSTS AND ESTATES.**

(1) For nonresident individuals, [or] trusts, ... 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. This is to be computed without the deductions for either the standard deduction or itemized deductions or personal exemptions except as provided in subsection (4) of this section.

(2) ....

(3) For the purposes of subsections (1) and (2) of this section:

(a) Income shall be considered derived from or relating to sources within Idaho when such income is attributable to or resulting from:

(i) Any business, trade, profession or occupation conducted or carried on in this state, including the distributive share of partnership income and deductions, and the pro rata share of S corporation income and deductions;

(ii) The ownership or disposition of any interest in real or tangible personal property located in this state;

(iii) The ownership or disposition of any interest in intangible personal property only to the extent that such property is employed in a business, trade, profession or occupation conducted or carried on in this state. Provided however, that interest income from an installment sale of real or tangible personal property shall

constitute income from sources within this state to the extent that the property sold was located within this state...;

The income and deductions used by the auditor are Idaho source income under subparagraphs (i) (for the partnerships and the business trust) and (ii) (for the commercial rental property before it was exchanged), although the taxpayers attribute this income to the Trust rather than the taxpayers directly.

The statute continues:

(iv) Income of estates and trusts distributed or distributable to nonresident or part-year resident beneficiaries ... when such income is derived from or related to sources within this state;

(v) ....<sup>3</sup>

Subparagraph (iv) creates Idaho source income for a nonresident beneficiary if the estate or trust of which he or she is a beneficiary distributes Idaho source income.<sup>4</sup>

The statute continues:

(b) ....

(c) ....

(d) The income of nonresident or part-year resident individuals, trusts or estates which is derived from or related to sources both within and without this state shall be attributable to this state in the manner prescribed in the rules of the state tax commission.

(4) ....

(5) ....

(6) For the purposes of subsections (1) and (2) of this section, deductions and adjustments allowed in computing the Idaho

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<sup>3</sup> In 1996, subparagraph (3)(a)(iv) was amended to read, “A resident estate or trust,” and new subparagraph (3)(a)(v) was added to read, “A nonresident estate or trust to the extent the income and deductions of the nonresident estate or trust were derived from or related to sources within this state[.]”

<sup>4</sup> See also § 63-3022(h)(through 1999) & (g)(2000 and later).

taxable income of nonresident and part-year resident individuals, trusts and estates shall be prescribed in the rules of the state tax commission. Such rules shall be based upon:

(a) Whether or not the deduction or adjustment is related to the production of income reportable to Idaho;

(b) Whether or not the deduction or adjustment is related to income received, expenses paid, or events of tax consequence which occurred during a portion of a taxable year that the taxpayer was domiciled in or residing in Idaho; or

(c) Any other appropriate basis for making the adjustment. An “appropriate basis” is one which the state tax commission finds is needed to insure that the amount of Idaho taxable income is fairly and reasonably related to a taxpayer’s activities in this state.

Thus, in 1996 and later years, under paragraph (3)(d) and subsection (6) of § 63-3026A, the sourcing of income and deductions to Idaho is accomplished by the Tax Commission’s rules.<sup>5</sup>

Under the rules, a nonresident individual’s Idaho source income includes profits from any business which has business situs in Idaho. Rule 080.03.a (1996); Rule 260.01 (1997 and later). It also includes rents from property located in Idaho, which would include the commercial rental property before it was exchanged. Rule 080.03.d (1996); Rule 264.01 (1997 and later). The taxpayers’ ownership of the latter property generates 100% Idaho source income.

There are no rules on sourcing deductions to Idaho, but the auditor’s treatment of both income and deductions here is supported by the taxpayer’s own assignments of deductions to the Idaho commercial rental income.

Idaho source income also includes gains, profits and income derived from any partnership having a business situs within Idaho, Rule 080.03.g (1996). Partnerships must apply the three-

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<sup>5</sup> Those two provisions delegate the definition of Idaho source income to the agency, so the rules promulgated under that authority have a higher dignity than typical “interpretive” rules. *Compare, K Mart Corp. v. Idaho State Tax Commission*, 111 Idaho 719, 722 (1986)(“Statutes control interpretive regulations.”), with *Appeal of Railbox Co.*, 116 Idaho 909, 911 (1989)(“Since the statute authorizes the Tax Commission to adopt regulations governing this aspect of taxation, it of course is free to abolish, modify or change its regulation ....”).

factor formula to determine “the income attributable to Idaho.” Rule 080.01 (1996). This treatment is specifically authorized by §§ 63-3022(k) and –3022L, both of which are discussed below.

Idaho Code § 63-3027 is not available to individuals to combine interests in separate entities.

I.C. § 63-3027 is entitled “Computing taxable income of corporations,” and begins: “The Idaho taxable income of any corporation with a business situs in this state shall be computed and taxed in accordance with the rules set forth in this section[.]” I.C. § 63-3027 is inapplicable at the Trust level or at the nonresident taxpayers’ individual level. *See Preston v. Idaho State Tax Commission*, 131 Idaho 502, 506 (1998)(pointing out that § 63-3027 applied to nonresident individuals only until 1975; § 63-3027A was enacted in 1974 and controls after 1975).

Rule 037 (1993-1996) provides for application of the three-factor formula to each trade or business of a single taxpayer, unless the businesses are unitary. Rule 040 (1993-1996) is similar, applying the three-factor formula to a “person acting as a business entity in more than one state.” Rules 037 and 040 are an interpretation of § 63-3027 and are therefore limited to situations where that Code section applies. At best, in the individual context, they apply to sole proprietorships. In 1997, in new Rule 340, the single business provisions were expressly limited to corporations.

A sole proprietor with a multistate business can apply the three-factor formula to that proprietorship, Rule 265 (1997 and later); but the taxpayers here are not sole proprietors;<sup>6</sup> and even if they were, they could not combine the proprietorship with other entities such as partnerships. Rule 360 (1997 and later)(combined report restricted to C corporations).

I.C. §§ 63-3022(k)(before 1996) and -3022L(2)(b)(1996-1999) provide that an S corporation and a partnership shall apply the corporate allocation and apportionment provisions of § 63-3027,

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<sup>6</sup> The directly owned real estate, including the rental real property, was not reported on a Schedule C. If it were, then the taxpayers would owe Social Security self-employment tax on the rental profits.

including the three-factor formula, at the entity level, passing through the Idaho portion to any Idaho nonresident shareholder or partner as Idaho source income. Rule 032 (1994-1996); Rule 263 (1997 and later). S corporations and partnerships doing no business in Idaho pass through no Idaho source losses to the return of an Idaho nonresident individual taxpayer.

Trust does not employ three-factor apportionment.

A trust does not apply the three-factor formula before 2000, but instead determines the sources of its income on individuals' principles when passing that income out to beneficiaries. Rule 261 (1997). The three-factor treatment was applied to estates or trusts in 2000 (§ 63-3022L(2)(b) as amended in 2000), which confirms that it is not available for the years at issue here.

(During the informal conferences, the parties discussed whether the Trust should be disregarded for income tax purposes due to its classification as a grantor trust under the IRC. The Tax Commission finds it unnecessary to opine on the question since the above reasoning is sufficient to support the result reached here.)

Statute of limitations is closed to refund in 1995.

In 1996, I. C. § 63-3026A was added to read in part:

**63-3026A.** COMPUTING IDAHO TAXABLE INCOME OF PART-YEAR OR NONRESIDENT INDIVIDUALS, TRUSTS AND ESTATES.

...

(4) In computing the Idaho taxable income of a part-year or nonresident individual..., the standard deduction or itemized deductions, as defined in section 63-3022(1), Idaho Code, if applicable, and the exemptions, as defined in section 151 of the internal revenue code<sup>7</sup> or any allowance in lieu of such deduction, shall be allowed in the proportion that paragraph (a) of this subsection bears to paragraph (b) of this subsection:

(a) The Idaho taxable income of the taxpayer modified as follows:

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<sup>7</sup> In 1998, the reference to the IRC was changed to capitalize the initial letters of the three words.

(i) No allowance shall be made for either the standard deduction or itemized deductions;

(ii) No deduction shall be made for personal exemptions or any allowance in lieu of such deduction.

(b) The Idaho taxable income as would be calculated for a resident of Idaho modified as follows:

(i) No allowance shall be made for either a standard deduction or itemized deductions;

(ii) No deduction shall be made for personal exemptions or any allowance in lieu of such deduction;

(iii) ...;

(iv) ....

(5) An adjustment may be made to eliminate distortions in the amount of net income attributable to a taxpayer's activities within the state of Idaho. Such deductions shall be limited to circumstances involving itemized deductions as referred to in subsection (4) of this section and which reflect:

(a) A failure to reflect the net income or deduction after reimbursements have been received; or

(b) A failure to reflect the net amount of mortgage interest income or expense from activities within Idaho.

There is no dispute regarding the mechanical application of these rules to 1995-1997. The federal NOL in 1997 had the effect of changing itemized deductions in 1994 through 1996, because the taxpayers' taxable income, computed as if they were residents, changed, which in turn affected the denominator of the fraction.

In 1995, the relevant portions of I.C. § 63-3072 read as follows (emphasis added):

**63-3072. CREDITS AND REFUNDS.**

(a) ....

(b) ....

(c) Except as provided in subsection (e) of section 63-3035, Idaho Code, a claim for credit or refund of tax, penalties, or interest paid shall be made within the *later of three (3) years of the due date of the return, without regard to extensions, or three (3) years from the date the return was filed.* However, with regard to remittances received with an extension of time to file, or a tentative return, a claim for credit or refund of such remittances shall be made within three (3) years from the due date of the return without regard to extensions. . . .

The amended 1997 return reporting carryback of a federal NOL was filed more than 3 years after the 1995 return was filed, so the regular statute of limitations under subsection (c) was closed. The statute continues (emphasis added):

(e) If a claim for credit or refund relates to an overpayment attributable to a net operating loss carryback, in lieu of the period of limitations prescribed in subsection (c) of this section, the period shall be that period which ends with the expiration of *the fifteenth day of the fortieth month following the end of the taxable year of the net operating loss which results in such carryback.*

The amended 1997 return reporting carryback of the federal NOL was filed within this statutory period, IF that is the applicable period. The statute continues:

(f) If an adjustment, which was made within the period of limitations as provided in this section, affects the amount of tax credit, net operating loss, or capital loss, claimed in a taxable year other than the tax year in which the adjustment is made, then adjustments to the credit, net operating loss, or capital loss, claimed in such other tax year may be made and a claim for credit or refund of tax, penalties or interest may be made even though such claim would otherwise be barred under the provisions of this section. ...

The 1997 adjustment was timely as to 1997, and IF there were an Idaho NOL in 1997 as the taxpayers claim using the three-factor method, AND IF it affects the amount of NOL claimed in 1995, then the claim for a 1995 refund would be timely. Since the audit was not conducted on the assumption that the three-factor method is allowed, it is uncertain whether these “ifs” are true.

Assuming, as the auditor has done and the Tax Commission decides here, that there is no Idaho NOL in 1997 because the three-factor method is prohibited, then the question becomes whether the 1997 return shows a “net operating loss carryback” within the meaning of subsection (e), above.

Net operating loss was defined in 1997 in pertinent part as follows:

**63-3021. NET OPERATING LOSS.**

(a) The term “net operating loss” means the amount by which Idaho taxable income, after making the modifications specified in subsection (b) of this section, is less than zero.

(b) Add the following amounts:

(1) The amount of any net operating loss deduction included in Idaho taxable income.

(2) In the case of a taxpayer other than a corporation:

(i) Any amount deducted due to losses in excess of gains from sales or exchanges of capital assets; and

(ii) Any deduction for long-term capital gains provided by this chapter.

(3) Any deduction allowed under section 151 of the Internal Revenue Code (relating to personal exemption) or any deduction in lieu of any such deduction.

(4) Any deduction for the standard or itemized deductions provided for in section 63 of the Internal Revenue Code, or section 63-3022(1), Idaho Code ....

Idaho in this Code section adopts its own definition of NOL, which must be read into the rest of the income tax act, including § 63-3072. Since no NOL in the Idaho sense was being carried back in the amended 1995 return, the applicable statute of limitations for purposes of the notice of deficiency determination was the regular three-year statute in subsection (c), and not the extended statute in subsection (e).

The auditor was therefore correct in denying the refund in 1995 for NOL carried back from 1997.

Penalty

The 1993 nonfiler penalty is affirmed because the 1993 return was not filed until 2001.

**Conclusion**

WHEREFORE, the Notice of Deficiency Determination dated September 28, 2001, is hereby MODIFIED, and as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following tax, penalty, and interest (computed through 3/21/03):

<u>YEAR</u>	<u>REFUND CLAIMED</u>	<u>REFUND (ALLOWED)</u>	<u>TAX DUE</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1991	\$ 10	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
1992	3,800	0	1,138	0	918	2,056
1993			98,412	24,603	68,853	191,868
1994	50,014	(8,313)			(3,250)	(11,563)
1995	63,762	(1,985)			(618)	(2,603)
1996	85,193	(4,909)			(1,184)	(6,093)
1997	15,025	0	0	0	0	0
1998	1,318	(1,283)			(374)	(1,657)
1999	10	0	0	0	0	0
					TOTAL	<u>\$172,008</u>

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

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

DATED this \_\_\_ day of \_\_\_\_\_, 2003.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this \_\_\_ day of \_\_\_\_\_, 2003, 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]