BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 16349
[Redacted]	)	
	)	DECISION
Petitioners.	)	
	)	

On December 7, 2002, the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to [Redacted] (petitioners), proposing additional income tax and interest for the taxable year 1998 in the total amount of $41,355. The petitioners filed a timely protest and petition for redetermination. A hearing was held on January 14, 2003. The Tax Commission, having reviewed the file, hereby issues its decision.

The Commission's Income Tax Audit Bureau (ITA) conducted an audit of petitioners' 1998 Idaho income tax return. As a result of that audit, ITA recalculated petitioners' Idaho taxable income as follows:

Idaho Taxable Income As Originally Filed	$119,620
ITA Adjustments:	
Capital loss from the sale of corporate stock	337,547
IRC section 1244 loss from the sale of corporate stock	33,741
Idaho net operating loss carryforward	44,625
Itemized deductions and personal exemptions	(1,945)
Idaho Taxable Income As Adjusted	$533,588

In their petition for redetermination dated January 14, 2002, the petitioners protest the adjustments made to their 1998 Idaho income tax return.

IN GENERAL

The petitioners filed an Idaho part-year income tax return for taxable year 1998. On the return the petitioners indicated that they had lived in Idaho for only five months. The petitioners and ITA are in agreement that the petitioners changed their domicile in 1998 from Idaho to [Redacted] at the end of May.

On the petitioners' federal income tax return, the petitioners reported from their investment in [Redacted]., an Idaho S corporation, $226,982 of ordinary income and $272,878 of capital gain. In 1998, Mr. [Redacted]was the president and major shareholder of [Redacted]. The $272,878 represents the petitioners' share of long-term capital gain recognized from the sale of Idaho property. Included in the $226,982 of ordinary income was the petitioners' portion of ordinary gain ($167,199) from the sale of the Idaho property that had been held for less than one year. In addition to reporting the gain from the sale of assets sold by [Redacted], the petitioners, as a result of the complete liquidation of [Redacted], reported a long-term capital loss of $404,459 and a $33,741 IRC section 1244 ordinary loss on the stock the petitioners held in [Redacted]. After netting the $404,459 long-term capital loss against the $272,878 of long-term capital gain being passed through from [Redacted] as well as a $61,669 long-term capital gain from the petitioners' sale of land during the period that the petitioners were still domiciled in Idaho, the petitioners reported a net long-term capital loss of $69,912 of which only $3,000 was deductible in taxable year 1998 in arriving at federal taxable income.

On the petitioners' Idaho nonresident income tax return, the petitioners treated the ordinary income and long-term capital gain from [Redacted] as Idaho source income. The petitioners treated the $33,741 IRC section 1244 ordinary loss and the $404,459 long-term capital loss as an Idaho source deduction. It is petitioners' treatment of these losses as a deduction in arriving at their 1998 Idaho taxable income that is the primary issue in dispute. ITA argues that the losses are [Redacted] source losses since the petitioners were domiciled in [Redacted] at the time the losses were recognized for tax purposes. The petitioners on the other hand argue that the losses are Idaho source losses since the petitioners were domiciled in Idaho at the time the losses were recognized or in the alternative, the losses are Idaho source since the losses were “attributable to or resulting from” the conduct of a business in Idaho. Furthermore, if ITA is correct and the capital loss is [Redacted] source, the petitioners argue that they should be allowed to claim the Idaho capital gains deduction on the $272,878 of Idaho capital gain passed through to the petitioners from [Redacted].

In another issue unrelated to the loss on the stock of [Redacted], the petitioners argue that they should not be required to carry back their Idaho net operating losses from taxable years 1996 and 1997 since a copy of the federal election to forego the federal carryback period was attached to the federal return that was attached to the Idaho return as originally filed. Since the petitioners failed to file an Idaho election to forego the Idaho carryback period, ITA carried the Idaho net operating losses back in order to determine the amount of loss available as a deduction in taxable year 1998.

ANALYSIS

1. General Overview of Idaho’s Taxation Of Part-Year Residents

Idaho Code section 63-3026A(2) governs the calculation of Idaho taxable income for a part-year resident.[1] That section provides as follows:

> (2) For part-year resident individuals, trusts or estates the term "Idaho taxable income" includes the total of: (a) Idaho taxable income as computed for a resident for the portion of the tax period during which a taxpayer is domiciled in or is residing in Idaho, plus (b) those components of Idaho taxable income which are derived from or related to sources within Idaho for that portion of the tax period during which a taxpayer is not domiciled in and is not residing in 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.

[1] Unless otherwise noted, cites to the Idaho Code refer to the Idaho Code in effect for taxable year 1998.

Whether income received by a part-year resident individual is derived from sources within Idaho is determined pursuant to Idaho Code section 63-3026A(3)(a). That section provides as follows:

> (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:
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> (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;
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> (ii) The ownership or disposition of any interest in real or tangible personal property located in this state;
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> (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. Provided further, that interest income received by a partner or shareholder of a partnership or S corporation from such partnership or S corporation shall constitute income from sources within this state to the extent that the partnership or S corporation is transacting business within this state;
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> (iv) A resident estate or trust;
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> (v) 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;
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> (vi) The conduct of pari-mutuel wagering, charitable gaming or any other form of gambling taking place within this state, except as expressly limited in section 67-7439, Idaho Code.

A different subsection, Idaho Code section 63-3026A(6), applies in determining whether a deduction claimed by a part-year resident individual is from an Idaho source and, therefore, allowed in computing that taxpayer's Idaho taxable income. Idaho Code section 63-3026A(6) provides:

> (6) For the purposes of subsections (1) and (2) of this section, deductions and adjustments allowed in computing the Idaho 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:
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> (a) Whether or not the deduction or adjustment is related to the production of income reportable to Idaho;
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> (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
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> (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.

The primary issue in this administrative protest deals with whether or not the losses incurred by the petitioners on the stock of [Redacted] as a result of the complete liquidation of [Redacted] were recognized for tax purposes during the period the petitioners were domiciled in or residing in Idaho and, if not, whether or not the losses were from an Idaho source.

Issue 1 – Treatment Of Losses On The Complete Liquidation Of [Redacted]

As a general rule, losses resulting from a complete liquidation will be recognized only after the corporation has made its final distribution. *Dresser v. United States*, 55 F.2d 499, 511-512 (Ct.Cl. 1932), *certiorari denied* 287 U.S. 635 (1932); *Turner Construction Co. v. United States*, 364 F.2d 525 (C.A. 2, 1966); Rev.Rul. 68-348, 1968-2 C.B. 141.

In *Dresser v. United States*, supra, the court stated:

> . . . when it appears, as here, that it is reasonably certain that the stockholders will receive a further liquidating dividend, a loss may not be allowed under the taxing act until there is a distribution of such dividend in property or money.
>
> The court explained the reason for this rule as follows:
> Until this is done the stock has a value to its owner, and the mere fact that because the corporation is in process of liquidation its value has declined in a particular taxable year to a figure which is less than cost does not entitle the stockholder to elect in which year he will take his loss. It often happens, as here, that the liquidation of a corporation extends over a period of years and a decision that a loss may be taken upon the basis of a valuation of the unliquidated assets and an estimate of the remaining liabilities and expenses would enable the taxing authorities to place the loss in a taxable year in which the taxpayer might have a very small income and would enable the taxpayer to select a taxable year in which to take the loss in which he might have a large income and thereby obtain a greater benefit from the loss.

Certain exceptions to the general rule have been recognized by the courts where the stock is shown to have been worthless prior to complete liquidation, such as, for example, where the corporation's liabilities exceeded its assets, *Dresser v. United States*, supra at 512; *Industrial Rayon Corp*. *v. Commissioner*, 94 F.2d 383 (C.A. 6, 1938), affirming a Memorandum Opinion of the Board of Tax Appeals; *Gowen v. Commissioner*, 65 F.2d 923 (C.A. 6, 1933), affirming 24 B.T.A. 1028, certiorari denied 290 U.S. 687 (1933); or where the losses are so reasonably certain in fact and ascertainable in amount as to justify their deductions before they were absolutely realized, *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *Commissioner v. Winthrop*, 98 F.2d 74 (C.A. 2, 1938), affirming 36 B.T.A. 314 (1937), acq. 1940-1 C.B. 5

One of the petitioners' representatives states in his letter dated July 11, 2003:

> There is no hard and fast rule in this area. Rather, each case requires an analysis of the status of the liquidation process at the point where either the taxpayers or the taxing authorities seek to recognize the loss. Clearly, the requirement is not that every step in

the liquidation process has been completed and every asset distributed.

The IRS itself has made that clear. In Rev. Rul. 69-334, the Service posited a situation where in 1966 the principal assets of a corporation (bonds of another corporation) were distributed to the shareholders, but with reservation for distribution later of a relatively small amount of cash. The cash was ultimately distributed in 1968. Following *Commissioner v. Winthrop*, 98 F.2d 74 (C.A.2, 1938), the ruling held:

> "[U]nder these facts, the loss on the liquidation was sustained in 1966 and was deductible for that year. ***"

The IRS acquiesced in the *Winthrop* decision at 1940-I C.B. 5.[1]

In Rev. Rul. 80-177, the IRS applied the doctrine of constructive receipt to reach the conclusion that a corporate liquidation was effectively complete for purposes of determining gain on liquidation when the corporation's obligations had been paid, its assets reduced to cash and there was reasonable certainty that the liquidation would be concluded.

Case law likewise supports such a facts and circumstances analysis of any given corporate liquidation for purposes of determining when gain or loss is recognized by the shareholders. The leading case on that point is *Winthrop*, referenced above. The facts of the *Winthrop* case were essentially the same as those of Rev. Rul. 69-334, with the Second Circuit reaching the same result.

Palmer v. U.S., a 1958 decision of the U.S. District Court in Connecticut (58-1 USTC ¶9288) also followed the *Winthrop* decision in finding that a liquidation for tax purposes occurred in the initial year (1952) when the corporation entered into a contract for sale of its assets and a portion of its stock was retired with a liquidating distribution; and not in the following four years when relatively small deferred payments of the asset sale proceeds were distributed. The District Court observed:

> "The amount to be received from the liquidating company could be valued in 1952 with certainty. There was no uncertainty as to the amount of cash paid by the purchaser; and the notes, payment of which would supply the remainder of the $10 per share to be distributed in liquidation, could

reasonably be valued at par, since they were secured by a first mortgage of property worth several times the face amount of the notes. Accordingly, I find that the taxpayers sustained in 1952 a long term capital loss of $100,500.13 on their Hendey stock. ***"

The application of these legal/tax principles to the facts here has been well-developed in the original protest filed by [Redacted], including his analysis of the facts of the relevant cases as compared to the facts attendant to [Redacted] liquidation. Clearly, the level of retained or undistributed assets disclosed by analysis of the cases and the level of undistributed assets for [Redacted] as of May 31, 1998 were substantially similar; and the conclusion is compelled that the loss on the stock of taxpayers was recognizable as of that time (May 31). Exactly how the liquidation would play out in the end was apparent at that time with just a few assets of known value still undistributed (small overpayment refund, bank account and the deferred portion of payment for the beet crop).

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[1]As one court put it later: "After the decision in the *Winthrop* case the Chief Counsel of the Internal Revenue Service revoked an earlier ruling to the contrary, and expressed his opinion 'that the decision of the court, affirming the decision of the Board, is correct.' G.C.M. 21966, 1940-1 Cum. Bull. 130; see also G.C.M. 22822, 1941-2 Cum. Bull. 126." *Palmer v. U.S.*, 58-1 USTC ¶9288, ftnte 3.

It appears that the Commission and the petitioners are in agreement that the facts and circumstances in this case will determine the point in time in which the petitioners would recognize for tax purposes the losses as a result of the complete liquidation of [Redacted]. As mentioned earlier, the general rule is that losses resulting from a complete liquidation will be recognized only at the point in which the corporation has made its final distribution. In the present case, according to information provided to the Commission, [Redacted] was dissolved on November 1, 1998. Therefore, under the general rule, the loss on the stock would be recognized for tax purposes on November 1, 1998. However, if the stock is shown to have been worthless prior to November 1, 1998, for example, where the corporation's liabilities exceeded its assets or where the losses are so reasonably certain in fact and ascertainable in amount as to justify their deductions before they were absolutely realized, the loss will be recognized for tax purposes on a date other than November 1, 1998. The petitioners do not argue that the stock was worthless prior to November 1, 1998, as a result of the corporation's liabilities having exceeded its assets; therefore, the Commission only need be concerned with whether or not the losses are so reasonably certain in fact and ascertainable in amount as to justify their deductions before November 1, 1998. In order to make this determination, the facts and circumstances surrounding the liquidation of [Redacted] needs to be reviewed. It does not appear that [Redacted] was liquidated in accordance with any formal written plan of liquidation. Nor does it appear that there is much in the way of written documentation regarding the steps taken during 1998 to liquidate [Redacted]. For example, no board minutes have been provided that contain discussions regarding the plan to liquidate [Redacted]. What is known about [Redacted] at the time of its liquidation in 1998 is as follows:

- [Redacted] was incorporated in Idaho on April 1, 1980.
- [Redacted] was dissolved on November 1, 1998.
- [Redacted] status was listed in the Idaho Secretary of State records as "ADMIN DISSOLVED, ADMIN DISSLV 17 Feb 2000"
- [Redacted] filed its 1998 Annual Report with the Secretary of State on October 12, 1998.
- [Redacted] listed on its 1998 federal 1120 a business activity of agriculture with a primary product of row crop.
- At the beginning of 1998 and at the time of the liquidation, the petitioners owned 52% of the stock of [Redacted].
- [Redacted] was the president of the corporation.
- The Idaho apportionment factor of [Redacted] for 1998 was 100%.
- At the beginning of 1998, [Redacted] on its federal from 1120S, page 4, Schedule L, reported assets totaling $1,258,423 and liabilities totaling $1,095,601.
- During 1998 [Redacted] owned grain stored in a commercial warehouse.
- [Redacted] reported that the following assets were sold or disposed of in 1998:

Property Held For More Than One Year

Date Sold	Asset	Sales Price	Cost	Gain
March 25, 1998	Beet Stock	$196,878	$100,100	$96,778
May 15, 1998	Farm Land	876,699	477,912	398,787

May 15, 1998	Crops	29,200	0	29,200
Total		$1,102,777	$578,012	$524,765

Property Held For Less Than One Year

Date Sold	Asset	Sales Price	Cost	Gain
March 25, 1998	Miscellaneous	$44,220	$23,764	$20,456
March 25, 1998	Various	260,300	$30,915	229,385
May 19, 1998	Various	144,398	$81,853	62,545
May 31, 1998	Various	79,991	$79,991	0
June 25, 1998	Various	9,150	$0	9,150
Total		$538,059	$216,523	$321,536

March 25, 1998, represents the date that assets were sold at auction by [Redacted] Auction Service. May 19, 1998, represents the date that [Redacted] sold farmland and an unharvested crop. May 15, 1998, and May 31, 1998, represent the dates that various assets were reported as having been disposed of on the "CURRENT YEAR DISPOSED ASSETS REPORT – SORTED BY Date acquired" report attached to federal form 4797. This report appears to have been prepared on January 25, 1999. The assets identified as having been disposed of included assets from the corporation's farm tractor, farm equipment, farm vehicles, and farm furniture and fixtures accounts. On this report two fully depreciated assets, a potato sorter and a potato piler, were listed as having been disposed of on June 25, 1998.

- The accounting for the various transactions did not take place until the end of 1998 as evidenced by the Adjusting Journal Entries made by the accountant for [Redacted]. In fact, the petitioners' representative clearly stated in his letter dated July 9, 2003, that "many of the sales and distribution of assets were not recorded on the books of [Redacted]"
- On a workpaper prepared by the accountant for [Redacted], the accountant identified the following assets as being part of the final liquidating distribution:

Cash	$ 8,965.35
Beet Stock Account Receivable	100,000.00
Beet Stock	5,210.18
Phyllis Account Receivable	8,972.50
Shareholder Receivables	455,994.54
Wheat Inventory	42,161.20
Total Assets	$621,303.77

ITA reviewed the information regarding the liquidation of [Redacted] in 1998 and determined that the petitioners' loss on the liquidation was incurred after the petitioners had changed their domicile to [Redacted]. ITA in its Notice of Deficiency Determination dated December 7, 2001, stated:

> In the present case, we are concerned with whether the corporate liquidation transpired prior to or after [Redacted]s move from Idaho to [Redacted] at the end of May in 1998. A letter from your representative stated:
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> > "[Redacted] did not farm in the year 1998, the farming equipment was sold in March 1998 and real property was sold in May 1998. The proceeds from the sale of equipment in March were used to pay corporate debt. The proceeds from the real estate sale were used on closing to pay the remaining corporate debt and the remaining cash from the sale was not paid to the corporation but was paid direct to the stockholders. Any other assets left were distributed to the shareholders in May 1998."
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> The facts as recorded on the books result in a different conclusion than the one stated above. The proceeds from the realty sale did wind up with shareholders but they were not treated as liquidating distributions on the corporate books but rather as shareholder receivables. Therefore, the proceeds from the sale were treated as received by the corporation.
>
> The books also report several assets that were not distributed in May of 1998 besides cash. As of November 1, 1998, the books reported the assets at liquidation of the following amounts:

Cash	$ 8,965.35
Beet Stock Account Receivable	100,000.00
Beet Stock	5,210.18
[Redacted] Account Receivable	8,972.50
Shareholder receivables	455,994.54
Wheat Inventory	42,161.20
Total Assets	$621,303.77

> Most of these accounts had various entries made between June and November of 1998. Thus, the final liquidation was not determinable in May of 1998. For example, the cash account wrote 64 checks for approximately $37,546.93 after May of 1998 through November 17, 1998. These checks not only affect the account balance of cash at liquidation but also have implications to other balance sheet and income statement accounts as well. Also,

two deposits totaling $25,270.94 were likewise recorded during this same time frame. These deposits also impact the balance sheet and income statement accounts.

Similarly, assets that were distributed to the shareholders remained on the corporate books at least through November when the liquidation entries were made. Some of these assets included [Redacted] home and various other equipment items that were not sold in the equipment auction. Thus, the conclusion is reached that the remaining assets after the real property was sold, were not distributed to the shareholders in May of 1998.

Additionally, the Idaho S Corporation Income Tax Return for [Redacted] stated that the corporation was dissolved on November 1, 1998. This also coincides with the information as recorded in the books of original entry. After examining all of these facts, the conclusion is reached that the final liquidating distribution appears to have occurred sometime in November of 1998 as was originally recorded in the books of original entry. Thus, the recognition of the loss for tax purposes occurs as of this date.

In the letter from your representative as outlined previously, he suggests that the realty proceeds from the sale that went directly to the shareholders be treated as liquidating distributions. This alternative view still results in the same conclusion. The only difference would be the shareholder accounts receivable would be substantially less. But all the other facts remain the same, specifically the fact as to whether all of the assets had been liquidated to cash or cash equivalents and the bills substantially paid so that the final distribution could be reasonably determined. The facts of this case point out that this was not completed until after May of 1998.

Therefore, the loss from the liquidation of the stock is treated as having occurred after [Redacted] had become a nonresident for Idaho income tax purposes. Since this loss is considered an intangible asset, the loss is sourced to the state of domicile at the time it was incurred which, in this case, was [Redacted]. Thus, the Idaho individual return was required to reflect only the shareholder's pro-rata share of the S corporation's capital gains of $334,547 resulting from the sale of Idaho tangible and real property. Since you reported a capital loss of $3,000, the total adjustment required to reflect the correct capital gain from Idaho sources is $337,547.

In the petition for redetermination dated January 14, 2002, the petitioners' accountant responded to the position taken by ITA as follows:

> State references to Rev. Rul. 68-348, *Dresser*, *Winthrop*, and *Schmidt*. In Rev Rul 68-348 the State does not fully quote the decision of the ruling. It goes on to say (this is not quoted by the State's report) that a taxpayer should also look at Winthrop (98 F.2d 74)"where a loss was sustained and allowed in the year the last substantial distribution was made because the amount of the final distribution was then determinable with reasonable certainty." Dresser can be distinguished from the current taxpayer because the unsold assets in Dresser were intangible assets such as goodwill, trade mark and trade name. These assets had not been valued; there had been no attempt to value them; and they are difficult to value. The court stated "...where there is no proof with respect to the value or lack of value on the particular date on which the loss is claimed, a loss through the liquidation of the corporation is not susceptible of determination..." In the present situation the amount to be received was known with reasonable certainty. Its value was quantifiable on May 31, 1998. In Winthrop the court decided that the amount not paid was known with enough certainty that the recognition of the loss should not be postponed until the final distribution. It is the taxpayer's position that the amount of the remaining distribution was known with sufficient accuracy that the recognition of the loss should not be postponed.
>
> The amount of assets remaining in the corporation on May 31, 1998 was $46,512.28 consisting of $21,241.34 in cash and 25,270.04 the amount receivable from [Redacted]. This represents 2.6% of the total net assets of the corporation. Also the distributions made to all the shareholders after May was 3.8% of the total distributions to the shareholders. In *Dresser* the unpaid amount was 12.2%. In *Schmidt* the unpaid amount was 49%. In *Winthrop* the unpaid amount was 1%. In the cases sited the courts use the term "substantial". We know then that 1% is not substantial but 12.2% is substantial. In our case we are 3.8%. The amount remaining in the corporation in the present case is clearly not substantial.
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> The State claims that distributions were not made until November 1998. This is not correct. All but $24,764.50 of $621,304 of total distributions were made prior to May 31, 1998. When the corporate transactions for the year were summarized a worksheet was prepared to keep track of distributions. On this worksheet the distribution account was not located in the equity section. This

> worksheet was used to accumulate distributions. It was not an official record of the Corporation. During the course of the liquidation cash distributions were made to the shareholders. These distributions were placed on the worksheet. Stock in [Redacted]was transferred to the shareholders. This was posted on the worksheet. Cash from the sale of land that was paid by the escrow company direct to the shareholders was posted to the worksheet. All other asset distributions were posted to this worksheet. The Company never planned or expected the shareholders to pay this back to the Corporation. It was considered a distribution in exchange for the stock of the Corporation by both the shareholders and the Corporation. There would have been no reason for the Corporation to give the cash to the shareholders if it was to be returned. The Corporation never requested a return of the assets distributed and the shareholders never offered to return assets. For the State to claim the amounts posted to this account were not distributions is incorrect. The substance of the transaction was that a distribution was made and no loan was made to the shareholders. (*Shore vs. Commissioner* US Court of Appeals 5th Circuit, No. 18319, 2-6-61)
>
> The taxpayers were Idaho residents when the decision to liquidate was made. They were residents of Idaho when the assets were sold and liabilities were paid. They were residents of Idaho when 96.2% of the distributions were made. At the time they moved from Idaho all transactions of the corporation were completed except the collection of the receivable from [Redacted] and the payment of miscellaneous, minor expenses of the corporation.

It is the Commission's belief that *Commissioner v. Winthrop*, supra, relied upon by petitioners is distinguishable. In that case, a corporation, pursuant to a plan of liquidation, distributed to each of its stockholders certain bonds and a "liquidation certificate" representing an interest in cash, the only remaining asset retained by it. The bonds had a definite market value, and the value of those received by the taxpayer was several thousand dollars less than the cost basis of his stock. The disbursement to be made against the retained cash for payment of taxes, expenses, and cost of dissolution were known with sufficient certainty to enable determination of the amount to be distributed in final liquidation. Based on such valuation, the liquidation certificate received by the taxpayer in 1932 had an estimated value of $900 and that was the amount actually received by him in 1934. It was held that the fact and amount of the taxpayer's loss on his stock was determinable with reasonable certainly in 1932.

In the present case, [Redacted] was in the process of liquidation but had not been finally and completely liquidated or dissolved in 1998 as of the end of May. It is unclear from the information provided to the Commission regarding the liquidation of [Redacted] exactly what assets the corporation retained title to as of May 31, 1998, or that the amount of the final liquidating distribution was known with reasonable certainty as of May 31, 1998. Therefore, the amount, which would ultimately be distributed in complete payment in exchange for all of the stock of the corporation, was indefinite and uncertain and not reasonably ascertainable as of May 31, 1998. For example, the petitioners could not produce any records to show that unsold shares of stock in [Redacted] were distributed to the shareholders before May 31, 1998, or that the grain owned by [Redacted] stored in a commercial warehouse was distributed to the shareholders before May 31, 1998. Furthermore, 64 checks totaling $37,546.93 were written on the corporate checking account after June 1, 1998. A review of the Account Transaction Summary Report, as well as the 1998 corporate income tax return for [Redacted], reflects that $21,747.78 of these expenditures were treated as operating expenses and the remaining $15,799.15 were treated initially as “Hired Labor” but reclassified at the end of the year to the shareholder accounts receivable account. According to the petitioners, the source documents relating to the $21,747,78 of expenditures were not retained. Accordingly, the petitioners cannot document that the disbursements to be made against the retained cash for payment of taxes, expenses, and cost of dissolution were known with sufficient certainty to enable determination of the amount to be distributed in final liquidation as of May 31, 1998.

[Redacted] Stock

It appears that [Redacted] held 250 shares of stock in [Redacted]. On [Redacted] 1998 federal schedule D, the corporation reported the sale of the stock as having occurred on March 25, 1998, resulting in a gain of $96,778 (sales price of $196,878 less basis of $100,100). In its letter dated January 23, 2003, the Commission posed the following questions to the petitioners' representative in an attempt to clarify the activity surrounding the sale of the stock:

> It appears that the stock your client held in [Redacted] was sold in three different transactions as follows:
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> - A deposit on April 14, 1998 (deposit 114) for $77,500 relating to the sale of beet stock to [Redacted] per the Account Transaction Summary report.
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> - A deposit on April 30, 1998 (deposit no. 115) for $19,375 relating to the sale of beet stock to [Redacted]per the Account Transaction Summary report.
>
> - A sale of 125 shares of beet stock to [Redacted] for a note receivable of $100,000 per the Memorandum Agreement dated June 16, 1998, between the [Redacted]s and the [Redacted].
>
> 1. On the Federal Schedule D for 1998, the date the stock was sold was listed as March 25, 1998, which seems to conflict with the dates listed above. Please explain?
>
> 2. Is it correct to say that the total number of beet stock shares held was 250 of which 125 were sold to unrelated third parties prior to June 1, 1998, and the remaining 125 shares were sold to an unrelated third party on June 14, 1998?
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> 3. The Memorandum Agreement documenting the sale of the stock on June 14, 1998, was between the [Redacted] and the [Redacted]. Therefore, please explain
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> - How the stocks ended up in the shareholders' hands and provide any documentation your client has in support of their explanation including correspondence from [Redacted] documenting when the name on the stock certificate\account was changed from [Redacted]. to the shareholders name.

- Why the note receivable of $100,000, was recorded as a corporate asset when the supporting document reflects that the note was to the shareholders? Did the shareholders contribute the note to [Redacted]?

The petitioners responded to the Commission's inquiry in a letter dated July 9, 2003, as follows:

> The Corporation sold some [Redacted] stock in March and April 1998. [Redacted] sold the remaining 125 shares of stock in June 1998. These 125 shares were distributed to [Redacted] in March 1998. [Redacted] negotiated a sale for the 125 shares in May 1998. On June 1, 1998 application was made to the Sugar Company to transfer the shares to the buyers. The shares were formally transferred by [Redacted] in October 1998. According to the Sugar Company it takes that long for them to complete the transfer. The agreement to sell the shares is in the name of [Redacted]. The name on the shares was not transferred from the Corporate name to the shareholders because there was not sufficient time between distribution and the sale to effect the name change.
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> The value of the Sugar Company stock had to be shown as income to [Redacted] on distribution to the shareholders. As we discussed previously, many of the sales and distributions of assets were not recorded on the books of [Redacted]. To do the tax return I had to accumulate the information on the sales and distributions and record the transactions. I accumulated the information on the working trial balance in a receivable account. I understand this was probably not the best choice of accounts.
>
> This did not mean that the Corporation was to be repaid these amounts. In fact the Corporation did not ask for payment nor did the shareholders ever believe they should repay these amounts. Both the shareholders' and [Redacted] considered the payments as distributions. In the particular case of the [Redacted] stock, income was recorded for $100,000, the value of the stock, and the debit was to the receivable account, which represented the distribution of the stock to the shareholders.

<u>Wheat Grain Inventory</u>

With respect to the grain stored at a commercial warehouse, the Commission posed the following question in its letter dated January 23, 2003:

> According to Journal Entry number 33, the shareholders received $42,161.20 worth of small grains inventory as part of the liquidation. Please identity the name, address, and phone number of the third party where the inventory was being warehoused and provide the Tax Commission with a statement from the warehouse identifying when title to the inventory transferred from [Redacted], Inc. to the shareholders.
>
> The petitioners responded to the question in a letter dated July 9, 2003, as follows:
> The Corporation also owned grain that was stored in a commercial warehouse. This grain was distributed in kind to the shareholders. The grain warehouse, through their normal procedures of deleting old records, has destroyed the records of the transactions. The shareholders no longer have their records of the sale. According to the shareholders, the grain was divided between them and each sold their share of grain independently of the other.

Post May 31, 1998, Expenditures

The Commission requested that the petitioners produce their source documents supporting the post May 31, 1998, expenses claimed as business expenses on [Redacted] return. The petitioners stated in their July 9, 2003, letter that:

> [Redacted] cannot find invoices for the expenditures after May 1998. However as noted previously in this report, as they examine the expenditures it is fairly clear that most of the checks written after May 1998 were personal in nature and should not have been deducted as business expenses.

Even without addressing the issue surrounding the use of the Shareholder Accounts Receivable raised by ITA or the fact that there were several assets listed as corporate assets that the petitioners claim were personal assets distributed to the respective shareholder before May 31, 1998, it is clear that that the petitioners cannot produce the necessary documentation to show that the shares of [Redacted] stock or the grain held at a commercial warehouse were distributed before May 31, 1998, or that the disbursement to be made against the retained cash for payment of taxes, expenses, and cost of dissolution were known with sufficient certainty to enable determination of the amount to be distributed in final liquidation as of May 31, 1998.

In *Ethel M. Schmidt*, 55, T. C. 335 (1970), Ethel Schmidt claimed a long-term capital loss on her Highland Co. stock in the amount of $10,440.36, which was applied as an offset in part against the long-term capital gain ($24,059.50) realized by her upon the sale of the [Redacted] Avenue property. The Highland Co. was organized in 1949, under the laws of Kentucky, to engage in the construction business as a contractor or subcontractor. During the year 1965, Ethel Schmidt owned 812 of the total 1,353 shares of common stock of the Highland Co. issued and outstanding. Her total tax basis in the 812 shares was $62,440.

On January 4, 1965, the stockholders of the Highland Co. unanimously adopted a resolution providing for the dissolution and liquidation of the assets of the Highland Co. A statement of intent to dissolve was prepared and filed in January 1965. The stockholders delivered all of the outstanding shares of the company to the secretary-treasurer of the company in 1965. The stock had not been formally canceled and the company had not been finally and completely dissolved in 1965. By the end of the year 1965, the Highland Co. had substantially liquidated its assets, <u>including **all** of its machinery and equipment, inventories, and other tangible personal property</u>. The remaining assets of the Highland Co. on December 31, 1965, consisted of cash in the amount of $2,551.68 and "street warrants" in the amount of $18,531.06 and other claims receivable from customers in the amount of $26,067.11 ($25,843.07 net of $224.04 reserve for bad debts). Outstanding liabilities were $4,281.10. A portion of these assets had been placed in the hands of an attorney for collection as they became delinquent. None of the remaining assets were of a type normally subject to appreciation in value.

Ethel Schmidt was the owner of the land and buildings at 644 Baxter Avenue on which the Highland Co. had conducted its business operations. She sold this property and relinquished possession to the purchaser on April 15, 1965. She realized a long-term capital gain in the amount of $24,059.50 upon the sale of the Baxter Avenue property.

By the end of the calendar year 1965, the Highland Co. did not have the assets (equipment), the employees, or the place of operations with and from which to conduct its usual business in the construction industry. The proceeds of the liquidation received by the Highland Co. during 1965 were applied in part to the payment of debts, and distributions aggregating $44,000 were made, pro rata, to the stockholders. Ethel Schmidt received $26,406.51 in liquidating dividends from the Highland Co. in 1965. The net worth, per books, of the Highland Co. as of December 31, 1965, was $42,644.71.

The court in *Schmidt* noted:

> It was abundantly clear at the end of 1965, that had all the remaining assets of the company been liquidated and the amounts thereof distributed to its stockholders in 1965, petitioner would have sustained a loss on her stock in the Highland Co. Since she had realized a substantial capital gain on the sale of the Baxter Avenue property, it is to her advantage, taxwise, to have the potential loss on her Highland Co. stock recognized in 1965 and offset against her capital gain.

Furthermore, the Court held:

> the Highland Co. was in the process of liquidation but had not been finally and completely liquidated or dissolved as of the end of 1965. It still retained substantial assets, no final liquidating distribution in cash or property had been made as of the end of 1965, and the amount that would eventually be distributed was indefinite and uncertain. The petitioner does not come within any of the recognizable exceptions to the general rule discussed above. We hold that petitioner is not entitled to a capital loss deduction on her Highland Co. stock in 1965, under the provisions of section 331(a)(1).

The case currently before the Commission contains a number of similarities with the *Schmidt* case. Like *Schmidt*, it is abundantly clear at the end of May, 1998, that, had all the remaining assets of [Redacted] been liquidated and the amounts thereof distributed to its stockholders in May, the petitioners would have sustained a loss on the stock in [Redacted] during the period that the petitioners were domiciled in Idaho. Since the petitioners had realized a substantial capital gain on the sale of land and from the sale of the Idaho property by [Redacted], it is to petitioners' advantage, taxwise, to have the potential loss on the [Redacted] stock recognized during the period that the petitioners were domiciled in Idaho and offset against their capital gain. Like the taxpayer in *Schmidt*, [Redacted] by the end of May had apparently neither the assets (equipment) nor the place of operations from which to conduct its usual business in the farming industry.

In *Schmidt*, the court noted that the net worth of the company being liquidated was $42,644.71 as of December 31, 1965. This amount appears to have been comprised of cash, customer accounts receivable, street warrants, and a small amount of debt. In the present case, the petitioners' representative argues that [Redacted] net worth as of May 31, 1998, was $39,344.35 made up of retained cash ($21,241.34), customer receivable ($25,258.56), loan overpayment receivable ($12.38) and debt ($7,718.03). It is the Commission's position that in addition to the $46,499.80 cash and customer receivable, the petitioners have not documented that [Redacted] disposed of the [Redacted] stock or grain inventory prior to May 31, 1998. The end result is that [Redacted] as of May 31, 1998, appears to have had a net worth well in excess of $100,000, hardly an insubstantial amount.

Like the court in *Schmidt*, and after careful review of the available facts, the Commission believes that the facts in this case do not support the petitioners' claim that the amount of petitioners' loss on the [Redacted] stock was determinable as of May 31, 1998. Therefore, the petitioners do not come within any of the recognizable exceptions to the general rule discussed above. Accordingly, the Commission holds that petitioners have not met their burden of showing that the exception to the general rule applies. Therefore, the petitioners are not entitled to treat the capital loss deduction or ordinary loss deduction relating to the petitioners' [Redacted]stock as having been incurred at the time the petitioners were domiciled in Idaho.

The Commission will now turn its attention to address whether or not the losses would be considered as being from an Idaho source. Under the Internal Revenue Code, gains from the sale or other disposition of property are considered "gross income." See I.R.C. section 61(a)(3); Tres. Reg. 1.61-6(a). Losses from the sale or disposition of property, on the other hand, are treated as a deduction allowed under Internal Revenue Code section 62 in arriving at "adjusted gross income." See I.R.C. section 62(a)(3); Tres. Reg. 1.62-1T(c)(4). Because a loss on the sale or disposition of property is treated as a deduction rather than as gross income, the source of the loss for Idaho income tax purposes is determined under Idaho Code section 63-3026A(6).

Idaho Code section 63-3026A(6) mandates that the source of deductions shall be determined in the manner set out in the administrative rules promulgated by the Idaho State Tax Commission. The administrative rules relating to the source of deductions and adjustments are currently set out in Idaho Income Tax Administrative Rules 250 through 275. Unfortunately, the Tax Commission has not yet promulgated any administrative rules expressly dealing with the source of loss from the sale or disposition of the type of property at issue in this case. As a result, the Administrative Rules of the Idaho State Tax Commission do not provide an answer to the issue raised in this protest.

Because the Idaho Code and the Idaho Income Tax Administrative Rules do not answer the precise question at issue in this protest, the Commission must look to extrinsic sources for guidance. In the past, the Idaho Supreme Court has looked to the federal income tax laws for guidance in determining the source of income where the Idaho legislature had not specifically provided a definition of the term "income from Idaho sources." *See Futura Corporation v. State Tax Commission*, 92 Idaho 288, 290-291, 442 P.2d 174, 176-177 (1968) (quoting with approval from Mertens, The Law of Federal Income Taxation.); *John Hancock Mutual Life Ins. Co. v. Neill*, 79 Idaho 385, 402, 319 P.2d 195, 203-204 (1957) (same.). Because there is no express legislative or regulatory answer to the precise question raised in this protest, the Commission finds that the general provisions of the Internal Revenue Code used for determining the source of loss on the sale or disposition of property provide a useful guide in determining whether a loss on the liquidation of a corporation is from an Idaho source.

Under the Internal Revenue Code, the Secretary of the Treasury is authorized to issue regulations relating to the source of losses from the sale of personal property. I.R.C. section 865(j)(1). The Treasury Regulations promulgated by the Secretary of the Treasury for determining the source of loss from the sale or disposition of personal property employ a very complex allocation and apportionment computation. Briefly stated, under the IRS Regulations, except as otherwise provided, losses recognized on the sale or other disposition of stock are allocated to the "class of gross income" (as defined in Treas. Reg. section 1.861-8(a)(3)) and, if necessary, apportioned between the "statuary grouping of gross income and the residual grouping of gross income" (defined in Treas. Reg. section 1.861-8(a)(4)), with respect to which gain from the sale of such stock would give rise in the hands of the seller. See Proposed Treas. Reg. section 1.865-1 and Treas. Reg. section 1.861-8(c)(7) (dealing with losses from personal property other than certain stock); Proposed Treas. Reg. section 1.865-2 (dealing with losses from certain stock). While this method of determining the source of losses from the sale of property is highly technical and requires a fairly advanced understanding of the federal income tax laws as they relate to nonresident aliens and foreign corporations, the legislative history of Internal Revenue Code section 865 goes on to provide that, in the absence of any specific factors causing the losses to be sourced otherwise, losses from the sale or disposition of personal property will be sourced in the same manner as if the transaction had resulted in a gain. See Joint Committee on Taxation, General Explanations of Tax Reform Act of 1986, pp. 922-923 (CCH 5/8/87). That is, as a general principle, Congress intended that the Treasury Regulations relating to the source of losses from the sale of property should, to the extent practicable, be consistent with the income sourcing provisions.

This approach of treating losses in a manner consistent with the treatment of gains is sensible. Therefore, in an effort to avoid unnecessary complexity in determining the source of loss from dealings in property, the Tax Commission feels that until such time as it promulgates a specific rule relating to the source of losses from the sale or disposition of the type of property, such losses should be sourced in the same manner as if the transaction had resulted in a gain. Under this approach, losses from dealings in property will be treated as Idaho source deductions under Idaho Code section 63-3026A(6) only if the transaction would have resulted in Idaho source income under Idaho Code section 63-3026A(3)(a)(ii) or (iii) had the property been disposed of at a gain.[2]

Source of Income and Deductions Relating to the Sale or Disposition of Intangible Property

[2] The Commission addressed this very issue in Docket Number 14437 published in 2000. See http://www2.state.id.us/tax/pdf/income/2000/0014437.pdf

For federal income tax purposes, it is undisputed that the loss at issue in this case was recognized in 1998 as the result of liquidation of the [Redacted] Subchapter S Corporation. Under I.R.C. section 331(a) money or property received by a shareholder in a complete liquidation of a corporation is treated as payment in exchange for stock. Therefore, the long-term capital loss as well as the IRC section 1244 ordinary loss recognized by the [Redacted]is treated as a loss on the disposition of their corporate stock, an intangible. Accordingly, in order for the loss to be deductible in arriving at the petitioners' Idaho taxable income, the petitioners have the burden of showing that loss on the disposition of the corporate stock is Idaho source under Idaho Code section 63-3026A(3)(a)(iii).

<u>Idaho Code Section 63-3026A(3)(a)(iii)</u>

In the absence of a Tax Commission administrative rule to the contrary, the determination of whether the loss from the disposition of corporate stock is from an Idaho source will be determined under Idaho Code section 63-3026A(3)(a)(iii). That section provides in part that income from the ownership or disposition of an interest in intangible personal property is considered to be Idaho source income "only to the extent that such property is employed in a business, trade, profession or occupation conducted or carried on" within Idaho. To the extent the intangible asset is not employed in a trade, business, occupation or profession within Idaho, the income or loss derived therefrom is not from an Idaho source.[3]

The statutory language set out in Idaho Code section 63-3026A(3)(a)(iii) is a codification of the common law doctrine of *mobilia sequuntur personam*. *Mobilia sequuntur personam* is a

[3] Idaho Code section 63-3026A(3)(a)(iii) goes on to provide two exceptions to the general rule that income from intangible property is sourced to Idaho only when the intangible property is utilized in a trade, business, profession or occupation taking place within this state. The first exception provides that interest income from the installment sale of real or tangible personal property located in Idaho will be treated as income from an Idaho source. The second exception provides that interest income received from loans made by a shareholder or partner to an S corporation or partnership doing business in Idaho will be treated as Idaho source income to the extent that the S corporation or partnership is transacting business within this state.

Latin term meaning "movables follow the person." This common law doctrine is a legal fiction that has its roots in ancient Roman law. Under the *mobilia* doctrine, movable property is said to have its situs in the place where its owner is domiciled. *United Gas Corporation v. Fontenot*, 129 So.2d 748, 752-755 (La. 1961). Although originally applicable only for purposes of establishing a situs for tangible property, the doctrine has for many years been applied to intangible property as well. Id.

Applying the concept of *mobilia sequuntur personam* to state taxation, courts have stated that intangible property is normally subject to taxation only by the state where the owner resides since that is where the property is deemed to have its situs. While the property is subject to taxation only by the state in which the property has its situs (i.e. where the property is deemed to be located), the income derived from the intangible property is not necessarily clothed with this same immunity. *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 313, 57 S.Ct. 466, 468 (1937).

Because of the formalistic and arbitrary nature of the *mobilia* doctrine, it did not take long for courts to formulate an exception that permitted a state other than the state of the owner's domicile to impose a tax on the intangible property. *United Gas Corporation*, supra. This exception, commonly referred to as the "business situs exception to the *mobilia* doctrine," is premised on the theory that intangible property could be utilized in a state other than the state of the owner's domicile in such a way as to render that property constitutionally susceptible to taxation in that other state. In other words, a state other than the state of the owner's domicile may, consistent with the Due Process Clause of the United States Constitution, tax the intangible property if that property is used in such a way as to create a "business situs" in that foreign state.

The common law *mobilia* doctrine has historically been applied with respect to property taxes or estate taxes. In its pure form, the legal fiction of *mobilia sequuntur personam* relates to a state's ability to tax the intangible property itself, not necessarily the income derived from that property. As pointed out by the United States Supreme Court in *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980):

> Although a fictionalized situs for intangible property sometimes has been invoked to avoid multiple taxation of ownership, there is nothing talismanic about the concepts of "business situs" or "commercial domicile" that automatically renders those concepts applicable when taxation of income from intangibles is at issue. The Court has observed that the maxim *mobilia sequuntur personam*, upon which these fictions of situs are based, "states a rule without disclosing the reasons for it." *First Bank Stock Corp. v. Minnesota*, 301 U.S., at 241, 57 S.Ct., at 680. The Court also has recognized that "the reason for a single place of taxation no longer obtains" when the taxpayer's activities with respect to the intangible property involves relations with more than one jurisdiction. *Curry v. McCanless*, 307 U.S. 357, 367, 59 S.Ct. 900, 906 (1939).

Mobil at 445, 100 S.Ct. 1235-1236 (some citations omitted).

While utilization of the *mobilia* fiction for determining the source of income from intangible property is not mandatory, most states by statute have chosen to follow the concept of *mobilia sequuntur personam* and the "business situs exception to the *mobilia* doctrine in determining the source of income received by nonresident individuals. California appears to be the first state to codify the *mobilia* doctrine in determining the source of income from intangible property. See California Revenue and Taxation Code Section 17952 ("Income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this State unless the property has acquired a business situs in this State.") (enacted in 1955). Today, most states that impose an individual income tax have followed California's lead and have codified the *mobilia* doctrine and the business situs exception. See, e.g., Alaska Statute Annotated section 43.20.0450(3); Arizona Revised Statute section 43-1092A; Colorado Revised Statute section 39-22-109(2)(a)(V); Connecticut General Statutes section 12-711(b)(2); New

York Tax Law Code section 631(b)(2); Oregon Revised Statute section 316.127(3); and Utah Code Annotated section 59-10-117(2)(a). Effective January 1, 1996, Idaho has adopted the *mobilia* doctrine and the companion business situs exception in determining the source of income received by nonresident individuals from intangible personal property. Idaho Code section 63-3026A(3)(a)(iii).[4]

For income or loss from the sale or other disposition of intangible property to have an Idaho source, the intangible asset (in this case the stock) must be utilized in a trade, business, profession or occupation taking place within Idaho. This statutory provision, codifying the "business situs exception" to the *mobilia* doctrine, recognizes that intangible assets can be utilized within Idaho in such a way that it is appropriate and constitutionally permissible for this state to tax the income associated with that intangible. In order to fit within the business situs exception to the *mobilia* doctrine, the intangible asset must by utilized by its owner in a meaningful way within the foreign states. As stated by the California Court of Appeals in *Christman v. Franchise Tax Board*, 64 Cal.App.3d 751, 134 Cal.Rptr. 725 (1976):

> It is well recognized that intangibles may be so employed by a nonresident in conjunction with his business that they acquire their own domicile, separate and distinct from that of the owner. . . . .
>
> The nub of the business situs concept is succinctly revealed in the earlier cases. '(I)ntangible property may acquire a situs for taxation other than at the domicil of the owner if it has become an integral part of some local business. (Citations.) Business situs arises from the act of the owner of the intangibles in employing the wealth represented thereby, as an integral portion of the business activity of the particular place, so that it becomes identified with the economic structure of that place. . . .' (*Holly Sugar Corp. v. Johnson,* 15 P.2d 8 at p. 11.)

Id. at 759, 134 Cal.Rptr. at 730.

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[4] Prior to the effective date of Idaho Code section 63-3026A(3)(a)(iii), Idaho did not follow the *mobilia* doctrine in determining the source of income from intangible property. *See Richards v. Idaho State Tax Commission*, 131 Idaho 476, 959 P.2d 457 (1998); *Futura Corporation v. State Tax Commission*, 92 Idaho 288, 442 P.2d 174 (1968).

The Tax Commission believes that the Idaho Legislature intended that a similar test be employed under the Idaho Income Tax Act in determining whether a non-domicillary individual has utilized his intangible property in a trade, business, profession or occupation in this state. Unless the intangible asset "has become an integral part of some local business" conducted or carried on within Idaho, the income or loss connected with the sale or other disposition of the intangible property is not from an Idaho source under Idaho Code section 63-3026A(3)(a)(iii). This finding is consistent with the interpretation taken by California and other states in cases involving similar statutory language. *See, e.g.*, *Christman*, *supra*; *In the Matter of the Appeals of Ames et. al.*, 1987 WL 50165 (Cal.St.Bd.Eq 1987); *Union Gas Corporation v. Fontenot*, 129 So.2d 748 (La. 1961). This finding is also consistent with Idaho Income Tax Administrative Rule 266.01.[5] That Administrative Rule, adopted July 1, 1999, provides as follows:

> 01. In General. Gross income from intangible property generally is sourced to the state of the owner's domicile. There are three (3) exceptions to this rule.
>
> a. If the intangible property is employed in the owner's trade, business or profession carried on within Idaho, any income derived from or related to the property, including gains from the sale thereof, constitute income from Idaho sources. <u>For example, if a nonresident pledges stocks, bonds or other intangible personal property as security for the payment of indebtedness incurred in connection with the nonresident's Idaho business operations, the intangible property has an Idaho situs and the income derived therefrom constitutes Idaho source income</u>.

IDAPA 35.01.01.266.01 (emphasis added).

In the present case, there is nothing to indicate that the petitioners used their stock in any meaningful or integral way in any trade, business, occupation or profession the petitioners carried on within Idaho. The petitioners' representative argues in his letter dated July 11, 2003:

[5] Rule 266.02 was formerly Idaho Income Tax Administrative Rule 260.02, adopted March 20, 1997.

> Idaho related income for the non-resident includes income "attributable to or resulting from" conduct of a business in Idaho and ownership or disposition of intangible property (like corporate stock) utilized in a business carried on in Idaho. While this farming business ([Redacted].) was generally in a liquidation and winding up phase in 1998, that is, nevertheless, an aspect of conduct of a business in the larger view (formation through liquidation), and certainly "attributable or resulting from" the conduct of a business.

Unfortunately for the petitioners, the test is whether the intangible asset itself, i.e. the stock in this case, was utilized in a meaningful or integral way in a trade, business, occupation or profession carried on within Idaho by the petitioners.[6] As indicated above, it does not appear that the petitioners utilized their stock in such a way as to give that stock a situs within Idaho. Therefore, the loss incurred by the petitioners is treated as being from a [Redacted] source, not an Idaho source, since the petitioners were domiciled within [Redacted] at the time the loss was incurred.

Issue 2 – The Idaho Capital Gains Deduction

In the petitioners' petition for redetermination the petitioners argue, "it is inequitable that the long-term capital gain deduction is disallowed for the taxpayer because the federal return shows no capital gains. This in effect hits the taxpayer twice and makes him pay more tax than he normally should." Accordingly, the petitioners argue that they should be entitled to claim the Idaho capital gains deduction on the sale of qualifying property.

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[6] In the Commission's decision in Docket Number 15253, published in 2001, the Commission stated that a "gain or loss from the disposition of an intangible may be, according to Rule 260, considered to be from an Idaho source if it is pledged as security for the payment of indebtedness incurred in connection with *the nonresident's Idaho business operations*." However, the Commission further concluded, "The *nonresident* and the corporation are two separate and distinct legal entities. Swope v. Swope, 112 Idaho 974, 981; 793 P.2d 273, 280 (1987). Even if it were to be found that the stock was pledged for the payment of the indebtedness of the corporation, it would not have been the business operation of the petitioners." *See* http://www2.state.id.us/tax/pdf/income/2001/0115253.pdf.

Idaho Code section 63-3022H provides taxpayers under certain circumstances an Idaho capital gains deduction as follows:

> **63-3022H. 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) <u>The deduction provided in this section is limited to the amount of the net capital gain from all property included in federal taxable income</u>. 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.
>
> (3) As used in this section "qualified property" means the following property having an Idaho situs at the time of sale:
>
> (a) Real property held at least eighteen (18) months;
>
> (b) Tangible personal property used in Idaho for at least twelve (12) months by a revenue-producing enterprise;
>
> (c) Cattle or horses held for breeding, draft, dairy or sporting purposes for at least twenty-four (24) months if more than one-half (1/2) of the taxpayer's gross income (as defined in section 61(a) of the internal revenue code) for the taxable year is from farming or ranching operations in Idaho;
>
> (d) Breeding livestock other than cattle or horses held at least twelve (12) months if more than one-half (1/2) of the taxpayer's gross income (as defined in section 61(a) of the internal revenue code) for the taxable year is from farming or ranching operations in Idaho;
>
> (e) Timber grown in Idaho and held at least twenty-four (24) months;
>
> (f) In determining the period for which property subject to this section has been held by a taxpayer, the provisions of section 1223 of the internal revenue code shall apply, except that when the holding period includes any period during which the taxpayer held property other than the property sold, all property held during the holding period must qualify under this section.
>
> (4) If an individual reports a capital gain from qualified property from an S corporation or a partnership, a deduction shall be allowed under this section only to the extent the individual held his interest in the income of the S corporation or the partnership for the time required by subsection (3) of this section for the property sold.
>
> (5) If an individual reports a capital gain from an estate, no

> deduction shall be allowed under this section unless the holding period required in subsection (3) of this section was satisfied by the decedent, the estate, or the beneficiary, or a combination thereof.
>
> (6) If an individual reports a capital gain from a trust, no deduction shall be allowed under this section unless the holding period required in subsection (3) of this section was satisfied by the grantor, the trust, or the beneficiary, or a combination thereof.
>
> (7) As used in this section "revenue-producing enterprise" means:
>
> (a) The production, assembly, fabrication, manufacture, or processing of any agricultural, mineral or manufactured product;
>
> (b) The storage, warehousing, distribution, or sale at wholesale of any products of agriculture, mining or manufacturing;
>
> (c) The feeding of livestock at a feedlot;
>
> (d) The operation of laboratories or other facilities for scientific, agricultural, animal husbandry, or industrial research, development, or testing.

(Emphasis added.)

Subsection (2) of this statute clearly states that "The deduction provided in this section is limited to the amount of the net capital gain from all property included in federal taxable income." Idaho Income Tax Administrative Rule 170.03.a. states "The Idaho capital gains deduction is allowed only if the taxpayer reports a net capital gain, as defined in Section 1222(11), Internal Revenue Code, on his federal income tax return." IDAPA 35.01.01.170.03. (1998). Internal Revenue Code section 1222(11) states "The term "net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year." For taxable year 1998, the petitioners ended up with a net long-term capital loss not a net capital gain. Accordingly, the limitation found in Idaho Code section 63-3022H(2) is applicable and the petitioners are not entitled to an Idaho capital gains deduction since the petitioners did not have a net capital gain from all property included in federal taxable income.

Issue 3 – the 1996 and 1997 Idaho Net Operating Loss

The petitioners claimed a $47,188 Idaho net operating loss deduction in arriving at their 1998 Idaho taxable income. The Idaho net operating loss deduction was from taxable years 1996 and 1997. ITA reviewed the petitioners' 1996 and 1997 Idaho income tax returns and discovered that the petitioners had not made an election to forego the Idaho carryback period when the petitioners had filed their 1996 and 1997 Idaho income tax returns. The petitioners had made an election to forego the federal carryback period in each of these years, but the petitioners did not attach a statement electing to forego the Idaho carryback period. The auditor recalculated what the amount of the allowable net operating deduction would be in taxable year 1998 and allowed an Idaho net operating loss deduction of only $2,563. In their petition for redertermination dated January 14, 2003, the petitioners argue:

> In 2001 the state legislature clarified what language is required for a taxpayer to forgo a net operating loss carry back. Effective January 1, 2002 a federal election form is sufficient to make the election. It appears that if the federal election is sufficient today, it should also have been sufficient in 1998. Since the taxpayer filed a federal election loss form with their Idaho return in 1998, they should be permitted to carry the loss forward to the year in question.

Idaho Code section 63-3022 governs the application of the petitioners' 1996 and 1997 Idaho net operating losses and for each of these years it stated, in part:

> (d) (1) A net operating loss for any taxable year commencing on and after January 1, 1990, shall be a net operating loss carryback not to exceed a total of one hundred thousand dollars ($100,000) to the three (3) immediately preceding taxable years. Any portion of the net operating loss not subtracted in the three (3) preceding years may be subtracted in the next fifteen (15) years succeeding the taxable year in which the loss arises in order until exhausted. The sum of the deductions may not exceed the amount of the net operating loss deduction incurred. *At the election of the taxpayer, the three (3) year carryback may be foregone and the loss subtracted from income received in taxable years arising in the next fifteen (15) years succeeding the taxable year in which the loss arises in order until exhausted. The election shall be made as*

> *under section 172(b)(3) of the Internal Revenue Code. An election under this subsection must be* <u>*in the manner prescribed in the rules of the state tax commission*</u> *and once made is irrevocable for the year in which it is made. . . .*

(Emphasis added.)

Idaho Income Tax Administrative Rule 201.(d) identifies the manner in which the election is to be made for tax years beginning prior to January 1, 2001 as well as tax years beginning on or after January 1, 2001. It states:

> 05. Timing And Method Of Electing To Forego Carryback.
>
> a. *Net operating losses incurred in taxable years beginning prior to January 1, 2001*. The election must be made by the due date of the loss year return, including extensions. Once the completed return is filed, the extension period expires. Unless otherwise provided in the Idaho return or in an Idaho form accompanying a return for the taxable year, the election referred to in this Subsection shall be made by attaching a statement to the taxpayer's income tax return for the taxable year of the loss. The statement must contain the following information:
>
> i. The name, address, and taxpayer's social security number or employer identification number;
>
> ii. A statement that the taxpayer makes the election pursuant to Section 63-3022(c)(1), Idaho Code, to forego the carryback provision; and
>
> iii. The amount of the net operating loss.
>
> b. *Net operating losses incurred in taxable years beginning on or after January 1, 2001*. The election must be made by the due date of the Idaho loss year return, including extensions. Once the completed Idaho return is filed, the extension period expires. The election shall be made by either attaching a copy of the federal election to forego the federal net operating loss carryback to the Idaho income tax return for the taxable year of the loss or following the requirements of Subsection 201.05.a.
>
> c. If the election is made on an amended or original return filed subsequent to the time allowed in Subsections 201.05.a. and

201.05.b., it is considered untimely and the net operating loss shall be applied as provided in Subsection 201.04.b.

IDAPA 35.01.01.2201.05 (2002). (Emphasis added). For taxable years beginning prior to 2001, a taxpayer had to make a separate election to specifically forego the Idaho carryback period. For taxable years beginning on or after 2001, the manner in which to make the election was changed to allow for the federal election. Therefore, a careful review of the Idaho statute and applicable rule reveals that the carryback of the 1996 and 1997 Idaho net operating loss was *mandatory* absent an election by the taxpayer to forgo the Idaho carryback period. In this case, the petitioners made no such election when they filed their 1996 and 1997 Idaho income tax return. Instead, the petitioners simply carried the net operating loss forward. The Idaho statute required the 1996 and 1997 Idaho net operating loss to be carried back to the prior three taxable years before the net operating loss could be carried forward. As a result of having been carried back to the prior three taxable years, the petitioners only had $2,563 available as a deduction in taxable year 1998.

WHEREFORE, the Notice of Deficiency Determination dated December 7, 2002, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax and interest :

YEAR	TAX	INTEREST	TOTAL
1998	$33,947	$11,198	$45,145

Interest is calculated through December 31, 2003, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

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

An explanation of the petitioners' rights 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]
[Redacted]

[Redacted]

____