

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 25370
[Redacted],)	
)	
Petitioners.)	DECISION
_____)	

On September 11, 2012, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (taxpayers), proposing additional income tax, penalty, and interest for taxable years 2008, 2009, and 2010, in the total amount of \$6,500.

The Income Tax Audit Bureau (Bureau) selected the taxpayers' 2008 through 2010 Idaho income tax returns for examination. The audit issues included Schedule E-Supplemental Income and Loss and Idaho Net Operating Loss Carryforward. The taxpayers' Schedule E for taxable years 2008 through 2010 showed net rental losses of \$48,998, \$38,331 and \$28,676 respectively. The Bureau requested specific documentation from the taxpayers to support the rental activity reported on their Schedule E. This documentation was furnished by the taxpayers and included invoices, receipts, schedules, books, and records. The Bureau reviewed the information provided by the taxpayers and made adjustments to each of the taxpayers' returns.

The Bureau sent the taxpayers an NODD. For taxable years 2008 through 2010, an adjustment was made to disallow the rental loss claimed, and for taxable year 2010, an adjustment was also made to disallow the Net Operating Loss Carryforward. Specific expenses either disallowed in their entirety, or reduced, included depreciation, and auto and travel. The taxpayers, through their appointed representative, submitted a timely petition for redetermination, the primary disagreement being the adjustment to depreciation. The Bureau

acknowledged the taxpayers' appeal and forwarded their file to the Legal/Tax Policy Division for administrative review.

The tax policy specialist sent the taxpayers' appointed representative a letter outlining the alternatives for having the NODD redetermined. The representative responded and requested an informal hearing. The hearing took place telephonically on February 20, 2013, with the majority of the discussion being the classification and subsequent recovery period for depreciation of the taxpayers' park model RV cabin they were using as rental property. No additional documentation was provided. The Commission, having reviewed all information contained in the file, hereby issues its decision.

Law and Analysis

In the present case, the taxpayers entered into an agreement with [Redacted] at [Redacted]. to: purchase a park model RV, lease a space in which to place said park model RV, and place their park model in the resort's "rental pool" allowing it to be rented for profit on a weekly/nightly basis.

Internal Revenue Code (IRC) sections 162 and 212 allow taxpayers to deduct ordinary and necessary expenses they paid or incurred during the year in carrying on a trade or business, and for the production of income. Most rental activity is considered a passive activity, which is defined in IRC section 469 as:

- (a) any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. IRC section 469(c)(1)
- (b) any rental activity (IRC section 469 (c) (2)) unless the taxpayer is a real estate professional (IRC 469 (c)(7))

A taxpayer can deduct losses from a passive activity only to the extent of income from a passive activity. The disallowed losses are carried forward to the following years and retain their

character as losses from passive activity. The carryforward losses are deductible in the subsequent years but only to the extent of income from passive activity. IRC section 469 (d)(1).

If the taxpayer actively participates in the rental activity and his modified adjusted gross income is less than \$100,000, he may be able to deduct a loss of up to \$25,000 in a tax year against non-passive income. IRC section 469(i)(2) and 469(i)(3)(A).

A taxpayer is considered to be actively participating if he participates in a significant and bona fide sense in making management decisions (such as approving new tenants, deciding on rental terms, approving capital expenditures) or arranging for others to provide services such as repairs. In addition, the taxpayer must own at least 10 percent of the property and not be a limited partner. IRC section 469(i)(6). The \$25,000 allowance would not be available if a management or rental agent handles all aspects of renting the unit and maintaining it. Madler v. Commissioner, T.C. Memo 1998-112.

The taxpayers in this case did not actively participate in the renting of the cabin, and in fact did not dispute the NODD because they were denied the \$25,000 loss against non-passive income. However, the law and analysis bears mentioning as it would be controlling even if the taxpayers were successful in their petition for redetermination of the protested issues.

As previously mentioned, the taxpayers' reason for appeal is centered on the class life determination and subsequent depreciation expense allowed on the rental property. The taxpayers' return showed a depreciation deduction for the rental unit of \$34,286, \$24,486 and \$17,486 respectively for taxable years 2008 through 2010. This amount was calculated based on the determination that the park model RV cabin qualified as seven year property. After reviewing the information provided by the taxpayers and conducting its own research, the Bureau determined the park model RV did not qualify as seven year property and the appropriate

recovery period for depreciation was 39 years. Based on a 39-year recovery period the Bureau recalculated the amount of allowable depreciation and made an adjustment to allow a depreciation deduction each year in the amount of \$3,590. The Bureau also made adjustments to other rental expenses which included the disallowance of auto and travel, and an adjustment to disallow a percentage of the expenses due to personal use of the rental unit. These adjustments reduced the taxpayers' schedule E rental losses for taxable years 2008 to 2010 as follows:

2008	(\$48,998) to (\$14,341)
2009	(\$38,331) to (\$14,794)
2010	(\$28,676) to (\$14,780)

The taxpayers reported income from rents of \$4,921 in taxable year 2008, \$3,269 in taxable year 2009, and \$2,533 in taxable year 2010. Regardless of the adjustments made by the Bureau, the taxpayers' Schedule E rental losses, due to their lack of active participation, would be limited to their income. Nonetheless, the Commission has reviewed the file and hereby issues its decision concerning the primary issue under appeal; the assignment by the Bureau of a 39-year life to the park model RV used a rental unit.

A park model is a structure built to RV ANSI 119.5 building code. The main limitation to a park model is that the dwelling has to be built under 400 square feet. Other than that the possibilities are endless. The structure utilizes building materials that you will find in residential construction (plaster board, tile, 2x4 and 2x6 framing, etc.) The structure is built on a single chassis and made to be semi portable from time-to-time, and not intended for regular towing. It does require a commercial trucking company with proper equipment to move from location to location.

Depreciation is an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property. It is an annual allowance for the wear and tear,

deterioration, or obsolescence of the property. A taxpayer must identify several items to ensure the proper depreciation of a property including the class life of the asset and the depreciation method for the property.

In the present case, the taxpayers determined their park model RV fit into the seven year class. This class includes property with a class life of 10 years or more, but less than 16 years, (Code Sec. 168(e)(1)), such as office furniture, fixtures, equipment, and property that doesn't have a class life and has not been designated by law as being in any other class. The taxpayers stated because the cabin is titled as a recreational vehicle, can be easily moved with little expense, and classified as personal property by the state of [Redacted] where cabin is located, that it falls into the seven year class.

The Bureau determined the rental cabin to be nonresidential real property, which is code section 1250 real property that is not (1) residential rental property or (2) property with a class life of less than 27.5 years (Code Sec.168(e)(2)(B)). The cost of nonresidential real property generally placed in service after May 12, 1993, is recovered over 39 years.

After reviewing the file, the Commission has determined the rental cabin more aptly resembles residential rental property, depreciated over 27.5 years. Residential rental property (Code Sec. 168(e)(2)(A)) includes buildings or structures with respect to which 80 percent or more of the gross rental income is from dwelling units. It also includes manufactured homes that are residential rental property. The Commission also made an adjustment to allow the auto and travel expenses previously disallowed by the Bureau.

The depreciation schedule and subsequent depreciation expense adjustment, based on a 27.5 year life is as follows:

Per Return					Depreciation Year:				
Asset	Cost	Date Acquired	Life	Method	2007	2008	2009	2010	2011
Rental Furnishing	7,631	1/1/2007	7	200DB HY	1,090	1,869	1,335	953	681
Trailer Rental Unit	140,000	1/1/2007	7	200DB HY	20,006	34,286	24,486	17,486	12,502
Total					21,096	36,155	25,821	18,439	13,183

Per Audit					Depreciation Year:				
Asset	Cost	Date Acquired	Life	Method	2007	2008	2009	2010	2011
Rental Furnishing	7,631	1/1/2007	7	200DB HY	1,090	1,869	1,335	953	681
Trailer Rental Unit	140,000	1/1/2007	27.5	SL MM	4,879	5,090	5,090	5,090	5,090
Total					5,969	6,959	6,425	6,044	5,772

Depreciation Expense Adjustment: 29,196 19,396 12,396 7,412

Conclusion

Deductions are a matter of legislative grace and the taxpayer bears the burden of showing that each deduction is allowable by statute. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 54 S.Ct. 788 (1934); Higgins v. C.I.R., T.C. Memo. 1984-330, (1984). The taxpayers have not met their burden. The taxpayers have not provided sufficient documentation that the park model cabin meets the requirements of property with a class life, and subsequent depreciation of seven years. However, the Commission has modified the depreciation schedule for the rental cabin prepared by the Bureau to reflect a residential rental property class and depreciation based over 27.5 years.

The Commission’s modifications to the Bureau’s determination, while relevant with respect to future depreciation and potential effect on income if/when the rental property is

disposed of, the modifications have no effect on the Bureau's adjustment to disallow the entire rental loss shown on the taxpayers' Schedule E.

THEREFORE, the Notice of Deficiency Determination dated October 4, 2012, is hereby AFFIRMED, and MADE FINAL.

IT IS ORDERED that the taxpayers pay the following tax, penalty and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2008	\$3,821	\$191	\$647	\$4,659
2009	155	10	21	186
2010	1,518	76	131	<u>1,725</u>
			Payment rec'd	<u>(3,821)</u>
			TOTAL DUE	\$2,749

Interest is calculated through February 12, 2013 for taxable year 2008 and through July 31, 2013 for taxable years 2009 and 2010.

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.

DATED this _____ day of _____ 2013.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2013, 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]
