

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

In the Matter of the Protest of	)	
	)	DOCKET NO. 24418
[Redacted],	)	
	)	
Petitioners.	)	DECISION
_____	)	

[Redacted] and [Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated June 15, 2011. The Notice of Deficiency Determination (NODD) asserted additional Idaho income tax, penalty, and interest in the total amounts of \$144,330 and \$103,516 for 2007 and 2008, respectively.

The petitioners have raised several issues to be resolved in this docket. They are as follows:

1. Should the denominator of the fraction set out in Idaho Code § 63-3029(3)(b) for determining this limitation be “adjusted gross income”, as set out in the statute, or some other number.
2. Should the state taxes added back pursuant to Idaho Code § 63-3022(j)(2) be computed to reflect all itemized deductions (including foreign taxes) deducted for Idaho purposes, or only those deducted for [Redacted] purposes?
3. Should the [Redacted] Margin tax be deemed to be an “income tax” and, therefore, be used for the computation of the credit for taxes paid to other states?
4. Should the [Redacted] Gross Receipts tax be deemed to be an “income tax” and, therefore, be used for the computation of the credit for taxes paid to other states?
5. Should the 5 percent negligence penalty pursuant to Idaho Code § 63-3046(a), be imposed?

Most of this decision deals with Idaho’s credit for taxes paid another state. The authority for the Idaho credit for taxes paid to another state is provided in Idaho Code §-3029, which stated, in pertinent part:

Credit for income taxes paid another state. (1) A resident individual shall be allowed a credit against the tax otherwise due under this chapter for the amount of any income tax imposed on the individual, an S corporation, partnership, limited liability company, or trust of which the individual is a shareholder, partner,

member, or beneficiary (to the extent attributable to the individual as a result of the individual's share of the S corporation's, partnership's, limited liability company's or trust's taxable income in another state), for the taxable year by another state on income derived from sources therein while domiciled in Idaho and that is also subject to tax under this chapter.

(2) For purposes of this section, "state" shall include any state of the United States, the District of Columbia, or any possession or territory of the United States.

(3) (a) Except as provided in subsection (3)(b), the credit provided under this section shall not exceed the proportion of the tax otherwise due under this chapter that the amount of the adjusted gross income of the taxpayer derived from sources in the other state as modified by this chapter bears to the adjusted gross income of the taxpayer as modified by this chapter. This limitation applies to all individuals.

(b) When tax is paid to another state on income of an S corporation, partnership, limited liability company, or trust, the limitation calculated in subsection (3)(a) with respect to that income shall be based on the proportion that the individual taxpayer's share of the entity's taxable income correctly reported to the other state under the laws of the other state bears to the individual's adjusted gross income. This limitation shall apply whether the tax is paid to the other state by the individual or by the S corporation, partnership, limited liability company or trust.

(c) The credit provided under this section shall further be limited to the tax paid to the other state.

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(6) The credit shall not be allowed if such other state allows a credit against taxes imposed by such state for taxes paid or payable under this act.

(7) For purposes of this section an income tax imposed on an S corporation, partnership, limited liability company, or trust includes:

(a) A direct tax imposed upon the income for the taxable year of the S corporation, partnership, limited liability company or trust; and

(b) An excise or franchise tax that is measured by the income for the taxable year of the S corporation, partnership, limited liability company, or trust.

(8) For purposes of subsection (7) of this section, an excise or franchise tax is "measured by income" only if the statute imposing the excise or franchise tax provides that the base for the tax:

(a) Includes:

(i) Revenue from sales;

(ii) Revenue from services rendered; and

(iii) Income from investments; and

(b) Permits a deduction for the cost of goods sold and the cost of services rendered. (Underlining added.)

## Issue 1 The Denominator

Idaho Code § 63-3029(3)(b) clearly defines the denominator to be adjusted gross income. The petitioners used Idaho adjusted income for the denominator. The auditor used the petitioners' [Redacted] adjusted gross income as the denominator. The petitioners contend that the use of adjusted gross income as a denominator is not a proper comparison with the numerator of the fraction and that it can produce a distorted effect. The Commission finds that Idaho law requires use of "adjusted gross income" irrespective of the result complained of by the petitioners.

In addressing another matter in which the taxpayer contended that the application of the law brought about an undesirable result, the Idaho Supreme Court stated, in part:

When construing the provisions of the Idaho Income Tax Code, however, we must enforce the law as written. Potlatch Corp. v. Idaho State Tax Comm'n, 128 Idaho 387, 913 P.2d 1157 (1996). If there is any ambiguity in the law concerning tax deductions, the law is to be construed strongly against the taxpayer. Id. This Court has no authority to rewrite the tax code. Bogner v. State Dep't of Revenue and Taxation, 107 Idaho 854, 693 P.2d 1056 (1984). Any exemption from taxation must be created or conferred in clear and plain language and cannot be made out by inference or implication. Herndon v. West, 87 Idaho 335, 393 P.2d 35 (1964). This Court does not have the authority to create deductions, exemptions, or tax credits. If the provisions of the tax code are socially or economically unsound, the power to correct it is legislative, not judicial. Id.

Idaho State Tax Commission v. Stang, 135 Idaho 800, 802-803, 25 P.3<sup>rd</sup> 113, 115-116 (2001).

Even if it were found that the application of the clear language of the law produced a "palpably absurd result," the courts have held that they must enforce the statute as written. The Idaho Supreme Court stated, in part:

Boise County contends that the legislature did not intend this result and points to the Statement of Purpose behind I.C. § 31-1506 to support this argument. However, where a statute is unambiguous, its plain language controls and this Court will not engage in statutory construction. Verska v. Saint Alphonsus Reg'l Med. Ctr., 151 Idaho 889, 893, 265 P.3d 502, 506 (2011).

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This Court does not have the authority to revise a statute that is unambiguous as written “on the ground that it is patently absurd or would produce absurd results when construed as written.” *Id.* at 896, 265 P.3d at 509.

Ravenscroft v. Boise County, 154 Idaho 613, 615-616, 301 P.3d 271, 273-274 (2013).

Idaho Code § 63-3011A defined “adjusted gross income:”

Adjusted gross income. The term “adjusted gross income” means adjusted gross income as defined in section 62 of the Internal Revenue Code.

Accordingly, the term “adjusted gross income”, as stated in Idaho Code § 63-3029, is clearly defined as “adjusted gross income” for [Redacted] purposes, which supports the adjustment made by the auditor. Therefore this adjustment made by the auditor is sustained.

#### Issue 2 Deductions

The auditor adjusted the amount of state income taxes that were deducted in computing [Redacted] taxable income, but were added back in computing Idaho taxable income. The difference between the petitioners’ calculation and the auditor’s calculation is the treatment of the foreign income taxes. A credit was claimed for these taxes on the petitioners’ [Redacted] return, but a deduction was claimed for these taxes on the petitioners’ Idaho income tax return. Idaho Code § 63-3022(j) provided for the deduction of the itemized deductions, including the foreign income taxes:

- (j) In the case of an individual, there shall be allowed as a deduction from gross income either (1) or (2) at the option of the taxpayer:
  - (1) The standard deduction as defined in section 63, Internal Revenue Code.
  - (2) Itemized deductions as defined in section 63 of the Internal Revenue Code except state or local taxes measured by net income and general sales taxes as either is defined in section 164 of the Internal Revenue Code.

Idaho Administrative Rule 121.03.a sets out the formula for determining the amount of the state taxes to be added back:

- a. If state and local income or general sales taxes are included in itemized deductions for federal purposes pursuant to Section 164, Internal Revenue Code,

they shall be added to taxable income. If itemized deductions are limited pursuant to Section 68, Internal Revenue Code, the amount of state and local income or general sales taxes added back shall be computed by dividing the amount of itemized deductions that are allowed to the taxpayer after all federal limitations by total itemized deductions before the Section 68 limitation.

Internal Revenue Code § 63 defines “itemized deductions” as follows:

(d) Itemized deductions.

For purposes of this subtitle, the term “itemized deductions” means the deductions allowable under this chapter other than —

- (1) the deductions allowable in arriving at adjusted gross income,  
and
- (2) the deduction for personal exemptions provided by section 151.

The Commission finds that the foreign income taxes were deductible only as an itemized deduction. Therefore, in accordance with Rule 121, they must be included in both the numerator and the denominator of this fraction, as it was applied by the auditor.

The Commission finds that the auditor correctly followed the formula set out in Rule 121.03 and that this is the correct application of the law.

### Issue 3 [Redacted] Margins Tax

The question for this issue is whether the [Redacted] Margins Tax paid in 2007 and 2008 is a creditable tax pursuant to Idaho Code § 63-3029. To be eligible, the tax must be measured by income and is further defined in the code as follows:

(8) For purposes of subsection (7) of this section, an excise or franchise tax is “measured by income” only if the statute imposing the excise or franchise tax provides that the base for the tax:

(a) Includes:

- (i) Revenue from sales;
- (ii) Revenue from services rendered; and
- (iii) Income from investments; and

(b) Permits a deduction for the cost of goods sold and the cost of services rendered.

The [Redacted] statute provided the following:

DETERMINATION OF TAXABLE MARGIN; ALLOCATION AND APPORTIONMENT

Sec. 171.101. DETERMINATION OF TAXABLE MARGIN.

- (a) The taxable margin of a taxable entity is computed by:
- (1) determining the taxable entity's margin, which is the lesser of:
    - (A) 70 percent of the taxable entity's total revenue from its entire business, as determined under Section 171.1011; or
    - (B) an amount computed by:
      - (i) determining the taxable entity's total revenue from its entire business, under Section 171.1011;
      - (ii) subtracting, at the election of the taxable entity, either:
        - (a) cost of goods sold, as determined under Section 171.1012; or
        - (b) compensation, as determined under Section 171.1013;
      - and
      - (iii) subtracting, in addition to any subtractions made under Subparagraph (ii)(a) or (b), compensation, as determined under Section 171.1013, paid to an individual during the period the individual is serving on active duty as a member of the armed forces of the United States if the individual is a resident of this state at the time the individual is ordered to active duty and the cost of training a replacement for the individual;
  - (2) apportioning the taxable entity's margin to this state as provided by Section 171.106 to determine the taxable entity's apportioned margin; and
  - (3) subtracting from the amount computed under Subdivision (2) any other allowable deductions to determine the taxable entity's taxable margin.

The base for the computation of the [Redacted] Margin Tax paid by the petitioners for both 2007 and 2008 was 70 percent of gross receipts. A tax on gross receipts clearly does not meet the requirements for a creditable tax pursuant to Idaho Code § 63-3029. However, the argument (from the petitioners' perspective) must be that "the statute imposing the excise or franchise tax . . . [p]ermits a deduction for the cost of goods sold and the cost of services rendered" even though that provision of the statute was not used in the computation of the tax paid by the petitioners.

Does the *statute* "permit a deduction for the cost of goods sold and the cost of services rendered?" There is certainly an argument that it does. These are deductible under one option of the [Redacted] Margins Tax. The cost of goods sold may be deducted under one option of the

statute. Sec 171.11(a)(1)(B)(ii)(a). Some services rendered may be deductible in the cost of goods sold and compensation is deductible under another provision. Sec. 171.101(a)(1)(B)(ii)(b). But these are not deductible under the portion of the statute under which the tax here in question was computed. The tax was applied to 70 percent of the company's gross receipts. If having another (inapplicable) option in the statute is sufficient to qualify a tax as a creditable tax, then almost any tax may, by legislative design, qualify even if the option is not used in the computation. The operative statute in this case simply applies a tax rate of .5 percent to 70 percent of the gross receipts of the firm. Therefore, it is a .35 percent (.5 percent x 70 percent) gross receipts tax.

As set out by the Idaho Supreme Court:

Where an ambiguity is found in tax statutes, the statutes are generally “strictly construed against the taxing authority and in favor of the taxpayer and ambiguities therein are to be resolved in favor of the taxpayer.” Department of Employment v. Diamond Int’l Corp., 96 Idaho 386, 387, 529 P.2d 782, 783 (1974). If there is ambiguity in a tax statute specifically regarding deductions, however, “the law is to be construed strongly against the taxpayer.” Potlatch Corp. v. Idaho State Tax Comm’n, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996); *see also* Manufab, Inc. v. Mississippi State Tax Comm’n, 808 So.2d 947, 949 (Miss.2002) (tax credits and exemptions construed strictly against taxpayer); Bennett v. State Dep’t of Assessments and Taxation, 143 Md.App. 356, 795 A.2d 124, 132 (Md.2001) (“It is a firmly established principle of law that exemptions from taxation are not favored, but are strictly construed in favor of the State.”); Hermann v. Director of Revenue, 47 S.W.3d 362, 365 (Mo.2001) (en banc), *reh’g denied*, (June 26, 2001) (“Tax credits and exemptions are construed strictly and narrowly against the taxpayer”); William Lyon Co. v. Franchise Tax Board, 4 Cal.App.4th 267, 5 Cal.Rptr.2d 680, 685 (1992) (same).

Canty v. Idaho State Tax Commission, 59 P.3d 983, 987 (2002).

The Commission finds that the verbiage in Idaho Code § 63-3029 regarding the qualifications for a tax measured by income must be applied to the tax actually imposed by the other state.

Idaho Code § 63-3029 was modified by the legislature in 2012. The intent of the change was that, after the effective date of the change, the [Redacted] Margins Tax would qualify as a creditable tax. The Statement of Purpose for that bill stated that “[t]his legislation clarifies that the [Redacted] tax is an income tax so income taxes paid to [Redacted] by an Idaho resident will be credited against the amount owed to Idaho, thus avoiding double taxation of the Idaho resident.” The petitioners contend that, since this is a clarification of the prior law, the modification should be applied to the years here before the Commission. However, the emergency clause in the legislation (House Bill 634) clearly stated that it was to be retroactive to January 1, 2012. The statement of purpose was not enacted into law. The statutes were. Joseph M. Verska, M.D. v. Saint Alphonsus Regional Medical Center, 151 Idaho 889, 892; 265 P.3d 502, 505 (2011). Where the statute is unambiguous, its plain language controls and the court will not engage in statutory construction. Ravenscroft v. Boise County, 301 P.3d 271, 273-274 (2013).

The Commission finds that the [Redacted] Margins tax, as computed in this matter, is not eligible for the credit provided for in Idaho Code § 63-3029.

#### Issue 4 [Redacted] Modified Gross Receipts Tax

The question here again is whether tax paid is eligible as a creditable tax pursuant to Idaho Code § 63-3029. The [Redacted] Modified Gross Receipts tax might more aptly be characterized as a subtraction method value added tax. The base is described in the [Redacted] law as “a taxpayer’s gross receipts . . . less purchases from other firms before apportionment under this act.” We again visit Idaho Code § 63-3029 (above) and see that a tax is “measured by income” “only if the statute imposing the excise or franchise tax provides that the base for the tax: (a) Includes: (i) Revenue from sales; (ii) Revenue from services rendered; and (iii) Income from

investments; and (b) Permits a deduction for the cost of goods sold and the cost of services rendered.”

The letter of protest filed on behalf of the petitioners stated, in part, “[b]y including the cost of inventory acquired during the year as a deduction from gross receipts, the tax base is effectively taking a deduction of cost of goods sold (albeit, cost of goods sold on a cash basis). Therefore, [Redacted] gross receipt tax is a tax measured by income as defined by Section 63-3029(8) and should be included in the Taxpayers’ credit for taxes paid to other states.”

The Idaho Supreme Court has stated that statutes providing for the allowance of credits should be construed strongly against the taxpayer. Canty v. Idaho State Tax Comm’n, supra, Kimbrough v. Idaho Board of Tax Appeals, 150 Idaho 417, 420, 247 P.3d 644, 647 (2011)

The Commission finds that the [Redacted] Modified Gross Receipts Tax is not a tax “measured by income” as defined in Idaho Code § 63-3029. While a portion of the qualifications have been met, there is clearly lacking the allowance of the cost of services rendered. Accordingly, credit for this tax is not allowed.

#### Issue 5 Negligence Penalty

The Commission finds that the negligence penalty is not appropriate for this docket.

THEREFORE, the Notice of Deficiency Determination dated June 15, 2011 is MODIFIED, and as so modified is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED, and THIS DOES ORDER, that the petitioners pay the following tax and interest (computed to October 31, 2014):

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$117,668	\$34,505	\$152,173
2008	89,057	20,400	<u>109,457</u>
		TOTAL	<u>\$261,630</u>

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

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2014.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2014, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.