

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
[Redacted],) DOCKET NO. 26228
)
)
Petitioners.) DECISION
)
_____)

BACKGROUND

On January 2, 2014, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioners) proposing income tax, penalty, and interest for taxable years 2010 and 2011 in the total amount of \$6,514. When referring to the Petitioner in the singular, we are referring to [Redacted]. On February 6, 2014, the Petitioners’ representative filed a timely protest, along with Idaho Power of Attorney forms naming [Redacted] and [Redacted] as their representatives (POAs). On March 21, 2014, the file was transferred to the Legal/Tax Policy Division for resolution. On June 30, 2014, the Commission sent a letter explaining the methods available for redetermining an NODD. The POA e-mailed a copy of the 2009 K-1, showing the net 1231 loss. A telephonic informal hearing was held on August 19, 2014. The Petitioners were represented by their POAs. The POAs restated their position that the character of pass-through income was not open to change for the tax year 2009.

During the hearing, the POAs requested an additional 10 days to review the returns and audit and to provide additional information. The Commission makes this decision after reviewing the information provided, along with the information available in the file.

ISSUES

1. Whether Audit can recalculate a Net Operating Loss (NOL) carryover into the 2010 and 2011 tax returns that originated in taxable year 2009, after the 2009 tax year was closed by the statute of limitations.
2. The Petitioner protests the change of the 2009 forms 1040 and 1065 after the three year statute of limitations.

DISCUSSION

The Petitioners formed a limited liability company called [Redacted] (LLC) in 2005. The LLC elected to file their income tax returns as a partnership. The LLC purchased real property located in [Redacted]. They rented the property and operated from 2005 through 2008, showing net income in the first three years and a loss in 2008.

The LLC filed their final Idaho partnership income tax return on April 7, 2009. According to Idaho Code section 63-3068¹, the statute of limitations is three years from the due date, without regard to extensions or the date the return was filed, whichever is later. The three year statute of limitations on the LLC's 2009 Idaho partnership return expired on April 15, 2012. The Petitioners filed their individual Idaho income tax returns for the taxable years 2009, 2010, and 2011 on March 15, 2010, March 17, 2011, and April 18, 2012, respectively. The three year statute expired, or will expire, April 15, 2013, April 15, 2014, and April 18, 2015, respectively.

On the 2009 LLC Partnership return, the liquidation of the Petitioner's Capital account was reported as a "Net Section 1231" loss of (\$173,372). "Net Section 1231" is referring to Internal Revenue Code (IRC) section 1231, property used in the trade or business and involuntary conversions. According to Treasury Regulation 1.1231.1, a net loss on the sale of business income is treated as an ordinary loss.

¹ The relevant portions of Idaho Code § 63-3068 included below.

Correspondence provided by the POAs during the audit described the termination of the LLC.

“As of 1/1/09, [Redacted] assigned his interest in [Redacted] to [Redacted]. [Redacted] reported a loss on his Form 1040, attachment 4797, in the amount of \$173,372.00. Enclosed is the worksheet of the preparer. The operating loss for [Redacted] was developed in the 2009 Form 1040. The loss reported on the Form 1045 of \$151,662.00 included a loss from other unrelated businesses in the amount of \$47,469.00, resulting in a [Redacted] loss carry forward of \$104,193.00².”

The liquidation of a partnership interest is defined by IRC § 741 as the sale of a Capital Asset. A loss on the liquidation of a partnership interest is a capital loss. IRC § 1211, “Limitation on Capital Losses”, limits the amount of capital losses which exceed capital gains that can be deducted in any one year to \$3,000 for an individual or married taxpayers filing jointly.

The Petitioners claimed an Idaho NOL carryforward on their 2010 Idaho individual income tax return of \$124,165. Audit requested information about the origin and calculation of that amount and discovered that the “loss” originated with the liquidation of the Petitioner’s LLC interest. Because of the capital nature of the loss, Audit recalculated the NOL carryover reported on the Petitioner’s 2010 and 2011 Idaho Individual Income Tax Returns as a capital loss carryover and limited the carryover amount to \$3,000 per year as required by IRC § 1211. The NODD did not make changes to taxable year 2009, as that year’s return was past the statute of limitations.

LAW AND ANALYSIS

First Issue: Whether Audit can recalculate a Net Operating Loss (NOL) carryover into the 2010 and 2011 tax returns that originated in the taxable year 2009, after the 2009 tax year was closed by the statute of limitations.

² Letter to the Idaho State Tax Commission, dated December 16, 2013, from [Redacted].

Idaho Code § 63-3068. PERIOD OF LIMITATIONS FOR ISSUING A NOTICE OF DEFICIENCY AND COLLECTION OF TAX.

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

63-3068.g, specifically deals with NOL and Capital Loss carryovers.

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

NOL and Capital Loss carrybacks and carryovers are also covered in the Idaho Income Tax Administrative Rules.

Idaho Income Tax Administrative Rule 201.

02. Adjustments to Net Operating Losses. (3-20-97)

a. Adjustments to a net operating loss will be determined pursuant to the law applicable to the loss year. (3-20-97)

b. Adjustments to a net operating loss deduction may be made even though the loss year is closed due to the statute of limitations.

03. Adjustments in Carryback and Carryover Years. (3-20-97)

a. Adjustments to income, including modifications pursuant to Section 63-3021, Idaho Code, in a carryback or carryover year must be made for purposes of determining, how much, if any, of the net operating loss may be carried over to subsequent years. (4-5-00)

b. Adjustments are made pursuant to the law applicable to the carryback or carryover year. (4-5-00)

c. Adjustments may be made even though the year is closed due to the statute of limitations. Underline added.

The statute of limitations in Idaho Code § 63-3068 limits collecting a tax or issuing a refund after the statute period. No tax was assessed for taxable year 2009, the closed year. The

Idaho statute that defines NOLs requires that gains and losses from the sale of capital assets be added back:

63-3021. Net operating loss.

(a) The term “net operating loss” means the amount by which Idaho taxable income, after making the modifications specified in subsection (b) of this section, is less than zero (0).

(b) Add the following amounts:

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

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

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

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

Internal Revenue Code § 741: Recognition and character of gain or loss on sale or exchange.

“In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).”
Underline added.

The loss on the sale of the Petitioner’s interest in the LLC is clearly a capital loss and not an ordinary loss. There was, in fact, no “business property” sold according to the LLC tax return. The LLC Form 4797 describes the exchange of the LLC ownership and not an asset that was owned by the LLC. There was no sale of LLC property. This was a transaction between the partners outside of the partnership. Reporting that transaction on the LLC’s tax return was an erroneous method of reporting a partnership termination.

CONCLUSION

Having reviewed the information available and the relevant law, the Commission makes this decision. Audit was correct in recalculating the Petitioners’ tax liability for taxable years 2010 and 2011.

First Issue: Since the liquidation of the Petitioner's LLC interest was a capital loss and not an ordinary loss as reported, Audit was correct to recalculate the loss carryover and limit the amount deducted to \$3,000 per year.

Second Issue: Audit recalculated the NOL carryover on the 2010 and 2011 Idaho Income Tax returns. The 2009 tax year is closed only to assessing tax or issuing refunds. The incorrect method of reporting the partnership liquidation cannot be reversed for assessing tax in a closed year, but the state does have the authority to correct the result of that mistake being carried into taxable years that remain open.

THEREFORE, the NODD dated January 2, 2014, and directed to [Redacted] is hereby AFFIRMED.

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/10	\$1,904	\$0	\$244	\$2,148
12/31/11	4,139	0	364	<u>4,503</u>
			TOTAL	<u>\$6,651</u>

Interest is calculated through September 30, 2014, 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' right to appeal this decision is enclosed.

DATED this _____ day of _____ 2014.

IDAHO STATE TAX COMMISSION

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.
