

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

In the Matter of the Protest of

██████

Petitioner.

DOCKET NO. 0-196-060-160

DECISION

██████ (Petitioner) protested the Notice of Deficiency Determination (Notice) for tax years 2020, 2021, and 2022 dated January 11, 2024. The Tax Commission reviewed the matter and hereby issues its final decision to modify the Notice.

**Background**

On October 15, 2021, Petitioner filed a Form 43, *Idaho Part-year Resident and Nonresident Income Tax Return*, for tax year 2020, indicating three months of Idaho residency. He filed a Form 40, *Idaho Individual Income Tax Return*, for tax year 2021 on October 7, 2022. He amended the returns for tax years 2020 and 2021 on January 30, 2023. Petitioner filed a Form 40 for tax year 2022 on October 13, 2023.

As part of normal procedures, the Tax Commission's Income Tax Audit Bureau (Audit) selected Petitioner's 2020 and 2021 returns for review. Audit sent letters to Petitioner and his appointed representative/attorney-in-fact ██████ (AIF B) on March 28, 2023, informing them that the 2021 amended return was under review and additional documentation was necessary. Audit requested the following documentation for tax year 2020: a copy of Idaho Form 39R; documents showing the date Petitioner became an Idaho resident; documents showing how the Idaho part-year income was calculated; and documentation of the transactions reported on federal Schedule D. AIF B provided documents in response.

Audit sent a request for additional information on June 16, 2023, asking for information regarding an addback of tax-exempt interest for 2020 and 2021, documentation related to the sale of an Idaho property in 2021 that was not reported on Petitioner's federal tax return, and an explanation for a discrepancy in reporting a federal net operating loss (NOL) addback. AIF B again provided documents in response.

Audit sent another request for additional information on July 11, 2023. Audit indicated an inability to determine how the tax-exempt interest and dividend amounts for 2020 and 2021 were calculated. Audit requested any previously unsubmitted statements or Form 1099 showing tax-exempt interest and dividends for 2020 and 2021, along with any calculations used to adjust the amounts reported on Petitioner's federal income tax return to meet Idaho requirements for reporting. AIF B again provided documents in response.

On August 14, 2023, Audit sent AIF B an email requesting loan documents/promissory notes related to pass-through entities involved in a lawsuit. Audit also asked a question regarding current-year losses from one pass-through entity. AIF B responded with the requested documents and information about the pass-through entity losses.

Audit and AIF B exchanged multiple emails, mainly containing updates on the status of Audit's review of the information AIF B had provided and the effects on Petitioner's 2020 and 2021 Idaho returns. This included an adjustment Audit made in a separate unprotested Notice for tax year 2019. That Notice did not result in any additional tax due from Petitioner, but it did affect a carryover item from 2019 to subsequent years. Because of the carryover issues created by potential adjustments, Audit expanded the review to include tax year 2022.

After managerial review, Audit issued the Notice on January 11, 2024. The Notice made changes to Petitioner's amended 2020 federal and Idaho returns:

- Increased Idaho Schedule E income based on a proration of pass-through losses and deductions from S corporations and partnerships that did not conduct business in Idaho during 2020<sup>1</sup>
- Increased Idaho Schedule E by removing passive losses carried forward from prior years that were incurred before Petitioner became an Idaho resident but not incurred from Idaho activity<sup>2</sup>
- Increased Idaho income by reducing an Idaho NOL carryforward from 2019<sup>3</sup>
- Decreased Idaho income by adjusting the addback for non-Idaho tax-exempt interest and dividends based on the portion of the year Petitioner was an Idaho resident
- Increased federal capital gains income by disallowing a loss for bad debt after determining that the debt in question “was assigned to another party” and “isn’t a bona fide debt”
- Increased Idaho capital gains income based on transactions that took place after Petitioner became an Idaho resident

In the Notice, Audit indicated that Petitioner’s 2021 amended return was received but not processed, so the adjustments are based on the original 2021 return. The adjustments Audit made for tax years 2021 and 2022 mostly stem from the adjustments for 2020. These include disallowing Idaho NOL carryover for both years after the Idaho NOL balance carried from 2019 to 2020 was reduced; based on Audit’s adjustments, it was completely used up in 2020. After Audit’s adjustment disallowing the bad debt loss in 2020, Petitioner no longer had any capital loss balance to carry forward to 2021 and 2022; Audit changed the net losses claimed each year to net gains based on transactions occurring during 2021 and 2022. Unrelated to the 2020 adjustments, Audit reduced the amount of federal NOL addback on Petitioner’s 2021 Idaho return<sup>4</sup>. Audit also

---

<sup>1</sup> For part-year residents, income, losses, and deductions passed through from entities that do not conduct business in Idaho are considered to be received ratably throughout the year and then prorated based on the portion of the year the taxpayer is an Idaho resident.

<sup>2</sup> Idaho part-year residents are taxed on all income from whatever source received during the portion of the year they are residents and on income received from Idaho sources during the portion of the year they are nonresidents.

<sup>3</sup> This was the result of the separate unprotested Notice issued for 2019.

<sup>4</sup> Federal NOLs and Idaho NOLs are calculated differently, so Idaho requires that any federal NOL carried forward or back and included in federal taxable income be added back before calculating Idaho taxable income. Petitioner reported \$369,710 NOL carried to his 2020 federal return but added back \$614,131 on his Idaho return.

recalculated credit for income tax paid to other states for 2021 and 2022 based on the new Idaho income and tax after adjustments.

In early February 2024, AIF B called Audit to express agreement with some parts of the Notice and disagreement with others, including disallowance of bad debt. He asked Audit about the process for submitting a protest letter.

Petitioner appointed a second representative/AIF – [REDACTED] (AIF M) – in March 2024. AIF M sent a timely protest letter, reserving the right to protest any issue, but specifically identifying two areas of disagreement. He wrote that the passive losses Audit disallowed (because they were incurred before Petitioner became an Idaho resident) should be allowed because they are no longer characterized as passive losses upon full disposition of the passive activity, and Petitioner disposed of the activities after he became an Idaho resident. This makes them “formerly passive losses,” and Idaho Code section 63-3022(i) does not use the term “formerly passive losses” in describing amounts that must be added back in calculating Idaho taxable income. The second specified area of disagreement was the disallowance of bad debt. AIF M wrote that the bad debt was not assigned to a true third party as Audit contended. Rather, it was assigned to the remaining owner of the pass-through entity to which Petitioner had loaned money through another single-owner LLC. While conceding that the promissory note may not be bad debt, AIF M stated that it would instead be considered a capital contribution, which would result in a long-term capital loss incurred during Petitioner’s time as an Idaho resident.

Audit sent letters to Petitioner and both AIFs acknowledging the protest and informing them that the case was being transferred to the Tax Commission’s Tax Appeals unit (Appeals) for continuation of the redetermination process. Appeals sent letters to Petitioner and both AIFs on April 17, 2024, outlining the options available for redetermining a protested Notice. After a brief



reasons not fully explained nor entirely relevant to this matter, the relationship between Petitioner and Mr. [REDACTED] soured and a lawsuit was filed.

One condition of the settlement agreement in the lawsuit was that Petitioner “shall promptly cause [REDACTED] [REDACTED] to assign all of its rights as a creditor and lender to [REDACTED] [REDACTED] and [REDACTED] [REDACTED] [REDACTED] to [REDACTED] including the two promissory notes from 2018 totaling just over two million dollars. The settlement agreement was signed by all required parties. The promissory notes clearly indicate that Petitioner made loans to [REDACTED] [REDACTED] [REDACTED] and [REDACTED] [REDACTED] that were intended to be paid back. The settlement agreement clearly indicates that Petitioner will never recover the amounts he loaned to these entities. The Tax Commission noted that the settlement agreement mentioned the loans to both [REDACTED] [REDACTED] [REDACTED] and [REDACTED] [REDACTED] but only the loan to [REDACTED] [REDACTED] was reported as bad debt on Petitioner’s 2020 income tax return.

The K-1 from [REDACTED] [REDACTED] [REDACTED] shows a recourse debt balance of \$729,919 at the beginning of 2020 and \$0 at the end of the year. The \$729,919 was reported as “capital contributed during the year” in the capital account analysis. This contribution was enough to offset Petitioner’s beginning negative capital account balance and result in a positive ending balance. Since Petitioner liquidated his ownership interest in 2020 with no consideration in return, the positive ending capital account balance was reported on Petitioner’s federal return as a long-term capital loss.

Similarly, the K-1 from [REDACTED] [REDACTED] shows a recourse debt balance of \$1,341,858 at the beginning of 2020 and \$0 at the end of the year. Unlike on the [REDACTED] [REDACTED] [REDACTED] K-1, however, the \$1,341,858 was not reported as “capital contributed during the year” in the capital account analysis, so there was no contribution to offset Petitioner’s beginning negative capital account balance. Since Petitioner liquidated his ownership interest in 2020 with no consideration in return,

the negative ending capital account balance was reported on Petitioner's federal return as a long-term capital gain. The outstanding recourse debt was reported as a short-term capital loss.

In his protest letter, AIF M argued that the outstanding [REDACTED] [REDACTED] debt was not assigned to a true third party. Rather, it was assigned to Mr. [REDACTED] the remaining owner of [REDACTED] [REDACTED]. AIF M stated that the promissory note represented cash invested in the partnership that was never recouped. He wrote that long-term capital gain (as reported on federal Form 8949 and Schedule D) was the result of Petitioner's negative beginning capital account balance. Had the assigned debt been treated as a capital contribution instead of bad debt, the resulting positive capital account balance would lead to a long-term capital loss (as happened with [REDACTED] [REDACTED] [REDACTED]).

Given the similarities in the loans Petitioner made to [REDACTED] [REDACTED] [REDACTED] and [REDACTED] [REDACTED] – the only difference being the amounts loaned – and the assignment of both debts to Mr. [REDACTED] it is logical that the treatment should be consistent. Therefore, the Tax Commission determined that the loan to [REDACTED] [REDACTED] should be treated as a capital contribution made during 2020. The resulting long-term capital loss is also treated as an Idaho loss because Petitioner disposed of his interest in the businesses after he became an Idaho resident.

In accordance with Internal Revenue Code (IRC) section 1211(b), Petitioner is allowed to claim a net capital loss of \$3,000 for federal and Idaho purposes for tax years 2020, 2021, and 2022.

#### *Prior Year Passive Losses*

AIF M explained in his protest letter that Petitioner had real estate investment outside Idaho before he became an Idaho resident. Because Petitioner had insufficient "hands-on" activity with the investments, the losses that were generated before Petitioner became an Idaho resident were characterized as passive losses under IRC section 469 until the investments were disposed of, at

which time they were no longer characterized as passive losses. He continues, writing that under IRC section 469(g)(1)(A) the losses became nonpassive due to Petitioner's disposition of the activities in 2020. He argues that "Idaho Code section 63-3022(i) only disallows passive losses deducted by the taxpayer in 2020 after became an Idaho resident." He states that the Idaho legislature selected the term "passive losses" and not "formerly passive losses" for Idaho Code section 63-3022(i).

The relevant part of Idaho Code section 63-3022(i) reads, "In the case of persons other than corporations, add any capital loss or passive loss deducted which was incurred in activities not taxable by Idaho at the time such loss was incurred." AIF M's statement that Idaho Code disallows passive losses deducted by a taxpayer after becoming an Idaho resident does not apply to tax year 2020 returns. A passive loss is not deductible in the year incurred. If it were incurred after a taxpayer became an Idaho resident, then that activity would be taxable by Idaho because residents are taxed on all income from any source. Therefore, when the passive activity is disposed of, the passive loss would be allowed for Idaho purposes. Idaho Code section 63-3022(i) applies only to activities that were not taxable at the time of the loss. This requires that the person incurring the loss is not an Idaho resident at the time of the loss and that the activity is not taking place in Idaho. What Idaho Code section 63-3022(i) requires is the addback of any capital loss or passive loss used in calculating federal taxable income if the loss was from an activity that was not taxable at the time it was incurred.

IRC section 469(a) disallows passive activity losses for individuals in the tax year incurred. IRC section 469(b) states that any loss disallowed under subsection (a) is to be treated as a loss in the next taxable year. IRC section 469(c) defines passive activity. IRC section 469(d) defines passive activity loss as the amount by which the total losses from all passive activities exceed the



total income from all passive activities; in general, passive losses can only offset passive income. IRC section 469(e) contains special rules for determining income or loss from a passive activity, which do not appear to apply in the present matter. IRC section 469(f) discusses the treatment of activities that in a previous tax year were passive but in a subsequent tax year are not passive. IRC section 469(g) reads in relevant part:

(g) Disposition of entire interest in passive activity. If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:

(1) Fully taxable transaction.

(A) In general. If all gain or loss realized on such disposition is recognized, the excess of—

(i) any loss from such activity for such taxable year (determined after the application of subsection (b)), over

(ii) any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)), shall be treated as a loss which is not from a passive activity.

Under IRC section 469(g)(1)(A), when a taxpayer disposes of a passive activity in a fully taxable transaction, passive losses from the activity incurred in the current year must be combined with passive losses from the activity carried forward from prior years, then be used to offset income or gains from other passive activities. If the result of this calculation is a loss, then it is treated as not being from passive activities. In other words, passive losses and income are the inputs of the calculation; the output of the calculation, if a loss, is not considered passive. IRC section 469(g)(1)(A) does not automatically recategorize passive losses from prior years as nonpassive, as AIF M appears to suggest when he calls them “formerly passive losses.” The Tax Commission was unable to locate any reference in IRC or Treasury Regulations to “formerly passive losses.”

Based on this analysis, the Tax Commission determined that Petitioner’s federal taxable income for 2020 was calculated using passive losses incurred in activities that were not taxable by Idaho at the time they were incurred, and those passive losses must therefore be added back. Had

the disposition of Petitioner's passive activities resulted in a net gain (even after accounting for all suspended passive losses), he would still be required to add back the passive losses deducted in calculating said gain.

*2021 amended return*

As Audit stated in the Notice, Petitioner's 2021 amended return was received but not processed. The adjustments to Idaho taxable income and tax are based on the original return filed on October 7, 2022. Petitioner's return, as filed, resulted in additional tax due of \$30,477. This amount was not paid. The adjustments in the Notice for 2021 result in a reduction of that additional tax due. The net amount to be paid will be provided in the Order to Pay below.

*Interest and penalty*

The Bureau added interest and penalty to Petitioner's tax deficiency. The Tax Commission reviewed those additions and finds them to be appropriate and in accordance with Idaho Code sections 63-3045 and 63-3046.

**Conclusion**

Petitioner's loans to two pass-through entities, representing a significant investment in the businesses, became unrecoverable in 2020 when his right to recoup the funds were assigned to another owner as part of an agreement to settle a lawsuit. Petitioner is entitled to claim a long-term capital loss for each unrecoverable loan. Petitioner must add back the suspended passive losses used in calculating taxable income for 2020.

THEREFORE, the Notice dated January 11, 2024, and directed to [REDACTED] [REDACTED] [REDACTED] is hereby MODIFIED and MADE FINAL.

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

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2020	\$0	\$0	\$0	\$0
2021	19,802	990	1,714	22,506
2022	1,385	69	70	<u>1,524</u>
				<u>\$24,030</u>

The Tax Commission DEMANDS immediate payment of this amount. Interest is calculated in accordance with Idaho Code section 63-3045.

An explanation of Petitioner's right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2025.

IDAHO STATE TAX COMMISSION

## CERTIFICATE OF SERVICE

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_, 2025,  
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:

Receipt No.

[REDACTED]

\_\_\_\_\_  
\_\_\_\_\_

[REDACTED]