

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-834-503-680
)	
)	
Petitioners.)	DECISION
_____)	

The Idaho State Tax Commission (Commission) reviewed your case, and this is our final decision. We uphold the Notice of Deficiency Determination (Notice) dated June 16, 2022. This means **you need to pay \$28,008** of tax, penalty, and interest for taxable years 2019, 2020, and 2021. The Commission now DEMANDS immediate payment of this amount.

BACKGROUND

The Commission issued a Notice to _____ (Petitioners) asserting additional tax, penalty, and interest of \$7,148 for taxable year 2019; \$11,114 for taxable year 2020; and \$9,442 for taxable year 2021. After applying a held refund from 2021 in the amount of \$811, it was determined that Petitioners owe a total of \$26,893 for taxable years 2019 through 2021. Petitioners timely protested the Notice.

This case arises due to an amendment to Petitioners' 2018 tax return to add a \$991,141 Ponzi loss on line 16 of Schedule A, Itemized Deductions, resulting from Petitioners' investments with _____. With the amendment, Petitioners' Idaho taxable income decreased from \$81,518 on the original return to \$0 on the amended return, and Petitioners were refunded the Idaho tax paid with their original 2018 return. For taxable years 2019, 2020, and 2021, Petitioners claimed an Idaho Net Operating Loss (NOL) carryforward related to their Ponzi loss. The auditor disallowed the carryforward deduction claimed in 2019, 2020 and 2021, stating, "You claimed a deduction for an NOL carryforward. Since you didn't report a loss on any of

your Idaho returns, you don't have an NOL to carry forward." Petitioners protested the auditor's findings, stating in part:

We believe that our NOL has been properly claimed and reported.

When we first started claiming this NOL, we were also audited by the IRS. The IRS found our NOL claim to be valid and we worked specifically with an auditor there to ensure that it was being claimed correctly on the Federal return. An amendment to the original 2019 Federal return was amended to reflect the audit results. The Federal return was used to transfer that NOL to the Idaho return. To that end, we have enclosed copies of our Federal audit with the IRS auditor's name that did the work. We are also enclosing a copy of our 2019 Federal amendment for reference. We request that our Idaho returns for 2019, 2020 and 2021 be reinstated as submitted as we believe that they were prepared properly and properly reflect our NOL. If the tax commission believes that this is still not correct, we would request a more detailed explanation stating specifically why Idaho is not allowing an NOL that is being properly claimed on the Federal return.

On September 19, 2022, the Tax Appeals Specialist sent Petitioners' appointed representative a letter explaining the methods available for redetermining the Notice. Petitioners' representative responded that Petitioners will not exercise their right to an informal hearing and the case should be decided based upon the information available. Subsequently, the Commission's Deputy Attorney General contacted Petitioners' representative to explain why the Ponzi loss did not create an NOL under Idaho law in 2018 and, therefore, there was no loss to carry forward into future years in 2019 through 2021. Petitioners' representative did not agree with the attorney's explanation and expressed Petitioners' desire to continue with their appeal. This decision follows.

ISSUE

Even though Petitioners had an NOL on their federal 2018 amended return, did they meet their burden of showing they had an Idaho NOL under Idaho Code § 63-3021 to carry forward on their 2019, 2020, and 2021 Idaho returns?

DISCUSSION

A. Itemized Deductions Generally Do Not Create and Are Not Part of the Idaho NOL

A taxpayer's federal taxable income is determined after subtracting either the standard deduction or itemized deductions from federal adjusted gross income. I.R.C. § 63. Likewise, the computation of Idaho taxable income allows the standard deduction or itemized deductions to be subtracted from gross income.¹ Idaho Code § 63-3022(j). Petitioners reason that because their amended itemized deductions of over one million dollars did not fully absorb their income in 2018, they should be entitled to carry forward the remaining deduction to lower Idaho taxable income in future years 2019 through 2021. However, there is no provision in Idaho law allowing itemized deductions to be carried forward. Only Idaho net operating losses can be carried forward.

The definition of an Idaho NOL in Idaho Code § 63-3021 is the “amount by which Idaho taxable income, after making the modifications specified in subsection (b) of this section, is less than zero (0).” Due to the modifications required by subsection (b), Petitioners did not have an Idaho net operating loss in 2018, despite having significant itemized deductions to lower their income.

Idaho Code § 63-3021(b) requires the following amounts to be added to Idaho taxable income before a finding of a net operating loss. If the taxpayer's Idaho taxable income is negative after adding the amounts back, the taxpayer has an Idaho NOL to be carried forward or back into other tax years. If it is \$0 or positive, there is no Idaho NOL. Subsection (b) states as follows:

(b) Add the following amounts:

¹ Note that state or local taxes are not allowed in the itemized deduction on the Idaho return. Idaho Code § 63-3022(j)(2). Taxpayers have the option of taking the standard deduction on the Idaho return even if they itemized on the federal return. Idaho Code § 63-3022(j).

- (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.
- (3) Any deduction allowed under section 151 of the Internal Revenue Code (relating to personal exemption) or any deduction in lieu of any such deduction.
- (4) **Any deduction for the standard or itemized deductions provided for in section 63 of the Internal Revenue Code, or section 63-3022(j), Idaho Code, except for any deduction allowable under section 165(c)(3) of the Internal Revenue Code (relating to casualty losses) pertaining to property physically located inside Idaho at the time of the casualty.**

Idaho Code § 63-3021(b) (emphasis added).

As stated above, itemized deductions are not allowed in the calculation of the Idaho NOL unless the deduction is allowable under I.R.C. § 165(c)(3) and pertains to property physically in Idaho. Idaho Code § 63-3021(b)(4). As explained more fully herein, a Ponzi loss is a deduction under I.R.C. § 165(c)(2) and not I.R.C. § 165(c)(3); thus, it is not allowed in the calculation of the Idaho NOL.

B. A Ponzi Loss Falls Under I.R.C. § 165(c)(2) Which Means It Does Not Create an Idaho NOL

Idaho follows the I.R.C. with respect to loss definitions. Idaho Code §§ 63-3002, 63-3011–63-3011C. I.R.C. § 165 states in pertinent part, as follows:

(a) General rule. --There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(c) Limitation on losses of individuals. --In the case of an individual, the deduction under subsection (a) shall be limited to--

- (1) losses incurred in a trade or business;
- (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

I.R.C. § 165.

Under the Tax Cuts and Jobs Act of 2017, losses under subsection I.R.C. § 165(c)(3)—the only type of itemized deduction that is allowed in the calculation of the Idaho NOL—are not deductible in taxable years 2018 through 2025 unless they are attributable to a Federally declared disaster. *See* I.R.C. § 165(h)(5). Since this loss was incurred in 2018 and not attributable to a declared disaster, it would not be deductible if it were determined to fall under I.R.C. § 165(c)(3). However, a Ponzi loss falls under I.R.C. § 165(c)(2) because it is incurred from a transaction entered into for profit. IRS Revenue Ruling 2009-09 addresses the tax treatment of losses from criminally fraudulent investment arrangements and confirms that a Ponzi loss is deductible under I.R.C. § 165(c)(2). (“In opening an investment account with B, A entered into a transaction for profit. A’s theft loss therefore is deductible under § 165(c)(2) and is not subject to the § 165(h) limitations.”)

Petitioners have stated on page two of their Form 1040X that the loss incurred in taxable year 2018 was a loss due to a Ponzi scheme by As noted above, itemized deductions—except a deduction allowable under I.R.C. § 163(c)(3) related to a casualty loss from property *physically located* in Idaho—must be added back when calculating the amount of an Idaho net operating loss. Following Idaho Code, Petitioners’ \$754,329 of itemized loss deduction claimed on their 2018 federal return is added back when calculating the Idaho NOL; therefore the \$754,329 of itemized loss deduction does not create an Idaho NOL in taxable year 2018 that could be carried forward to their 2019, 2020, and 2021 Idaho individual income tax returns.

C. A Federal NOL Does Not Create an Idaho NOL.

Pursuant to Idaho Code § 63-3022(b), a taxpayer’s federal NOL deduction must be added back to federal taxable income when calculating Idaho taxable income. In other words, Idaho

does not conform to the federal NOL. Idaho has its own state specific NOL, as outlined in Idaho Code § 63-3021(b) above. As such, a taxpayer may have a federal NOL to carry forward but no corresponding Idaho NOL to carry forward, because the federal NOL does not affect a taxpayer's Idaho taxable income. The federal NOL and the Idaho NOL are entirely different.

D. The IRS' Allowance of the Ponzi Loss Deduction is Irrelevant to this Case.

In their protest, Petitioners provided IRS tax documents showing the IRS reviewed and allowed, but adjusted, Petitioners' itemized deduction for the Ponzi loss. The IRS determined that the taxpayers must elect to use the safe harbor treatment as provided in Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, if they wished to claim the loss deduction in 2018, because during that year they had a reasonable prospect to recover at least a portion of the investment. The taxpayers agreed to use the safe harbor treatment and limit the deduction to 75% or \$754,329 on Schedule A, line 16. The IRS noted that the remaining \$251,443 of loss is suspended to offset any potential recovery in future years; recovered amounts up to that amount are tax free and amounts greater than that amount must be included in taxable income. Once there is no longer any chance of recovery, Petitioners may deduct the unused suspended loss on Schedule A.

The IRS documents provided by Petitioners show how they were allowed to claim \$754,329 of itemized loss deduction on their 2018 federal return and that they might be able to deduct up to \$251,443 in some future year if there is no longer a chance of recovery. However, this information does not change the Idaho net operating loss calculation because, as explained above and below, Idaho Code § 63-3021 adds back all \$754,329 of the itemized deduction amount when calculating the Idaho NOL.

E. Petitioners Have Not Shown the Commission's Notice is Erroneous

In Idaho, it is well established that the Commission's Notice of Deficiency is presumed to be correct, and the taxpayer bears the burden of showing the deficiency is erroneous. *Parsons v. Idaho State Tax Commission*, 110 Idaho 572, 574-575 n.2, 716 P.2d 1344, 1346-1347 n.2 (Ct. App. 1986); *Albertson's, Inc. v. State, Dept. of Revenue*, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984). 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 US. 435, 54 S. Ct. 788 (1934). The Commission does not have discretion to allow the Ponzi loss in the calculation of the Idaho NOL and must enforce the law as written. *Potlatch Corp. v. Idaho State Tax Comm'n*, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996). If the provisions of the tax code are socially or economically unsound, the power to correct it is legislative. *Idaho State Tax Comm'n v. Stang*, 135 Idaho 800, 803, 25 P.3d 113, 116 (2001).

INTEREST AND PENALTIES ARE AFFIRMED

The auditor added statutory interest pursuant to Idaho Code § 63-3045. Once a deficiency is determined, the addition of interest is mandatory. Idaho Code § 63-3045(7)(a)–(b); *Union Pacific R. Co. v. State Tax Comm'n*, 105 Idaho 471, 670 P.2d 878 (1983). The auditor also added the negligence penalty. Idaho Code § 63-3046(a) provides that a five percent (5%) negligence penalty shall be assessed if any part of any deficiency is due to negligence or disregard of rule but without intent to defraud. A penalty is justified when a taxpayer files a return that contains substantial errors and makes unsubstantiated claims of deductions. IDAPA 35.02.01.410.02.b–c. Petitioners' 2019 through 2021 returns claimed unsubstantiated NOL carry forward deductions. The Commission finds that the auditor correctly included interest and the negligence penalty.

THEREFORE, the Notice of Deficiency Determination dated June 16, 2022, is hereby APPROVED and MADE FINAL.

IT IS ORDERED that Petitioners pay the following amount of tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2019	\$6,436	\$322	\$695	\$7,453
2020	10,278	514	759	11,551
2021	8,952	407	456	9,815
Total	25,666	1,243	1,910	28,819
				(811)
			Total Due	<u>\$28,008</u>

Interest is calculated through August 4, 2023.

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 _____ 2023.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2023,
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.

Copy mailed to: