

BEFORE THE MONTANA TAX APPEAL BOARD

FILED

AUG 30 2018

Montana Tax Appeal Board

ELEANORE R. ALLEN,

Appellant,

v.

**STATE OF MONTANA,
DEPARTMENT OF REVENUE,**

Respondent.

CASE No: IT-2018-23
(Tax year 2013 through 2016)

**FINDINGS OF FACT,
CONCLUSIONS OF LAW, ORDER,
AND OPPORTUNITY FOR JUDICIAL
REVIEW**

Eleanore R. Allen timely appealed the Montana Department of Revenue (DOR) Office of Dispute Resolution (ODR) Order of January 25, 2018. ODR upheld the DOR's final determination that Mrs. Allen should not have subtracted her deferred compensation payments received from Washington State from her Montana adjusted gross income.

The Board held a hearing on May 30, 2018.

For the reasons provided herein, Mrs. Allen's appeal is denied in part and granted in part.

ISSUES

Whether Mrs. Allen can subtract her deferred compensation payments from her Montana adjusted gross income.

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Findings of Fact

1. Eleanor Allen moved to Montana near the end of 2000 and has been a full-time resident since 2001. MTAB Hrg. 15:00-15:32.
2. Prior to moving to Montana, Mrs. Allen lived and worked in Washington state. MTAB Hrg. 14:45-15:20. While she was working she contributed part of her income to an employer sponsored deferred compensation account. MTAB Hrg. 8:16-10:27.
3. The amounts Mrs. Allen contributed to her deferred compensation account were pre-tax contributions; meaning Mrs. Allen did not include the amounts she contributed to the deferred compensation account in her adjusted gross income as reported on her federal income tax return in the year those contributions were made. Ex. B; ODR Exs. 1-2. Mrs. Allen testified that all of the contributions were made while she was a Washington state resident so she does not believe the current distributions are Montana source income. MTAB Hrg. 9:08-10:27.
4. Mrs. Allen retired in September of 2000, and she provided the Board with a copy of the year-end statement for her Washington State Deferred Compensation – which under the “Your Contribution Summary” states that all of the contributions to the account were “Employee Pre-Tax.” Ex. B.
5. For the years under audit, 2012 through 2016, Mrs. Allen received distributions from the deferred compensation account. Ex. A.
6. For the years under audit, Mrs. Allen filed Montana Individual Tax Returns wherein she reported the amounts she received from her deferred compensation account in her federal adjusted gross income, but then she deducted that amount to reach her Montana adjusted gross income. Ex A.

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7. Mrs. Allen testified that she simply followed the instructions for “Line 7 Schedule II – Recoveries of Amounts Deducted in Earlier Years That Did Not Reduce Montana Income” from the DOR’s instructions pamphlet published each year as “Montana Form 2 Individual Income Tax Forms and Instructions.” MTAB Hrg. 11:12-12:07. The instruction for Line 7 Schedule II of the 2016 instructions reads as follows:

If you are required to include in your federal adjusted gross income any amounts that you recovered from a previous federal income tax deduction and if this previous deduction did not reduce your Montana tax liability in the year of that deduction, you can subtract the amount of this recovery from your Montana adjusted gross income. Ex. 3; Ex. E¹.

8. Mrs. Allen testified that the distributions from her deferred compensation account were amounts she had to include in her federal adjusted gross income, that had previously been a deduction from her federal adjusted gross income, and, because she was living in Washington state at the time she had taken the deductions to her federal adjusted gross income they did not reduce her Montana tax liability in the year of the deduction – and thus she was simply following the form’s instructions and subtracted her deferred compensation distributions on Schedule II to calculate her Montana adjusted gross income. MTAB Hrg. 11:12-12:07.
9. Ms. Allen testified that she did not know whether Montana law allowed her to deduct her distributions from her deferred compensation account. MTAB Hrg. 11:45-12:10.

¹ The instructions are substantially identical for each of the years under audit.

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10. Tyler Walker testified on behalf of the DOR. Mr. Walker testified that he is an individual income tax (IIT) field auditor for the DOR. MTAB Hrg. 16:40-17:04.
11. Mr. Walker testified that as part of his job he gets leads assigned to him by his supervisor, which means there is something of interest on a tax return that he is asked to investigate. MTAB Hrg. 18:20-19:00.
12. Mr. Walker testified that Ms. Allen's returns were assigned to him as a lead, and that he conducted a desk audit wherein he wrote a letter to Mrs. Allen asking her to explain the Schedule II deductions she had reported. MTAB Hrg. 19:00-20:20.
13. Mr. Walker testified that he spoke to Mrs. Allen on the phone and she explained that the Schedule II deductions were the amounts that she contributed to her deferred compensation account before she was a Montana state resident and so she subtracted that from her Montana taxable income. MTAB Hrg. 25:15-26:00.
14. Mr. Walker concluded that Mrs. Allen's contributions to her deferred compensation account were contributed pre-tax, meaning they were not taxed at the federal level in the year of contribution, thus, they are subject to Montana tax in the year of distribution. MTAB Hrg. 26:00-33:05. He sent Mrs. Allen a letter stating that the DOR was not going to allow her Line 7 Schedule II contributions for tax years 2012 – 2016. MTAB Hrg. 32:10-33:20.
15. Brian Olson, the DOR's Unit Manager of the IIT Field Audit unit, testified that federal adjusted gross income is the starting point for determining Montana adjusted gross income. MTAB Hrg. 42:00-49:00.
16. Mr. Olson testified that M.C.A. § 15-30-2110 lists the specific deductions Montana taxpayers are allowed to take from their federal adjusted gross

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- income to reach their Montana adjusted gross income, and those deductions are reported by taxpayers on Schedule II. MTAB Hrg. 1:00:30-1:04:00. Any item listed on Line 7 of Schedule II must be authorized in M.C.A. §15-30-2110, and specifically this line prevents a Montana taxpayer from being double taxed by Montana on an item of income reported on the federal return. MTAB Hrg. 59:10-1:00:45.
17. Mr. Olson testified that to understand Line 7 he wanted to explain line 6 above, which address state income taxes and the tax benefit rule: if, for example, someone deducts their state income taxes on their federal return and then the following year includes their state tax refund on their federal return – since Montana did not allow the taxpayer to take the deduction for state income taxes in the prior year, that taxpayer can deduct the inclusion of the state refund when calculating their Montana adjusted gross income in the year the refund is received. *Id.*
 18. Mr. Olson explained that Line 7 is the same concept to address the problem of the tax benefit rule as line 6, but for items of recovery other than state taxes, for example if a taxpayer deducts their medical expenses on their federal return but not their state return, and insurance reimburses the taxpayer for some of those medical expenses in a later year the taxpayer does not need to include that reimbursed amount in their income – so it is a line item that is used far less frequently. MTAB Hrg. 1:00:00-1:00:32; 1:10:10-1:0:55.
 19. Mr. Olson testified that Line 7 is not intended to permit taxpayers to deduct their distributions from deferred compensation account as part of their Montana income tax calculation. MTAB Hrg. 1:00:50-1:01:14.
 20. Mr. Olson testified that it is uncommon for anything to show on Line 7 of Schedule II, and estimated that less than 1 percent of all Montana

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individual income tax returns report anything on this line each year.

MTAB Hrg. 1:10:00-1:10:10.

21. Mr. Olson testified that Montana law does not allow a Montana resident to deduct their deferred compensation distributions from their Montana adjusted gross income, regardless of where the taxpayer was living at the time the contributions were made, because the distributions are considered Montana source income as soon as taxpayers become Montana state residents. MTAB Hrg. 1:02:00-1:04:40.
22. To whatever extent the following conclusions of law may be construed as findings of fact, they are incorporated accordingly.

Conclusions of Law

23. To whatever extent the foregoing findings of fact may be construed as conclusions of law, they are incorporated accordingly.
24. The Board has jurisdiction over this appeal. MCA § 15-2-302.
25. The DOR is an agency of the executive branch of government, created and existing under the authority MCA §2-15-13. The DOR is charged with the administration and enforcement of the Montana Code Annotated, Title 15, chapter 20 (Individual Income Tax) and the ancillary Administrative Rules of Montana Title 42, chapter 15.
26. If, in the opinion of the DOR, a return of a taxpayer is in any essential respect incorrect, the agency may revise the return. MCA §15-30-2605(1).
27. Montana follows federal law for purposes of calculating gross income and adjusted gross income. MCA §§15-30-2101(10) and 2110(1).

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28. Unless a specific income exclusion applies, a taxpayer is required to include in gross income all income from whatever source derived. 26 U.S.C. §61(a).
29. MCA §15-30-2101(25)(d) states that “pension and annuity income” includes “distributions from individual retirement, deferred compensation, and self-employed retirement plans.”
30. Tax deductions are a matter of legislative grace and it is the taxpayer’s burden to clearly demonstrate the right to the claimed deductions. *Robinson v. DOR*, 2012 MT 145, ¶12, 265 Mont. 336, 340, 281 P. 3d 218, 222. The “burden of showing the right to the claimed deduction is on the taxpayer.” *INDPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).
31. MCA §15-30-2110(2) lists the deductions a Montana taxpayer can deduct on Schedule II for purposes of calculating their Montana adjusted gross income. Line 7 of Schedule II corresponds to MCA §15-30-2110(2)(m), commonly known as the tax benefit rule, which states “the recovery during the tax year of any amount deducted in any prior tax year to the extent that the recovered amount did not reduce the taxpayer’s Montana income tax in the year deducted.”
32. Under federal law, the tax benefit rule requires “that a recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery.” *Nash v. United States*, 398 U.S. 1, 3, 90 S. Ct. 1550, 1551, 26 L. Ed. 2d 1 (1968). Montana thus enacted into law the deduction provided for in subsection (2)(m), cited above, to ensure that a taxpayer who is following the tax benefit rule under federal law, can deduct that item from their Montana adjusted gross income in the year of recovery if it was something Montana did not allow the taxpayer to deduct that item in the original year reported.

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33. The deferred compensation distributions that Mrs. Allen receives while she is a resident of Montana are defined, by law, to be Montana source income. Nothing in Montana law allows her to deduct those distributions because she made the contributions to that account when she was not a Montana resident.
34. The DOR's instructions for Line 7 Schedule II are not determinative of the issue of whether a deduction is provided for and allowed under Montana law. *Rabideau v. Comm.*, 1997 Tax Ct. Memo LEXIS 265 (T.C. 1997). While this Board found Mrs. Allen's testimony credible, and her interpretation of the instructions understandable, we cannot grant the relief she seeks regarding her claim that her deferred compensation is not Montana source income.
35. The Board does however find that Mrs. Allen demonstrated reasonable cause for why she took the deductions on Schedule II, and pursuant to MCA §15-1-206, orders the DOR to waive all late-payment penalties.

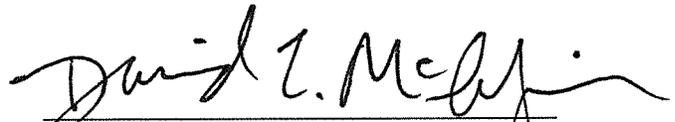
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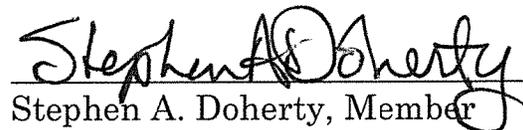
ORDER

IT IS HEREBY ORDERED that Eleanor R. Allen's appeal is DENIED IN PART and GRANTED IN PART such that the adjustments to the tax owed by Mrs. Allen for the years 2012-2016 shall be due and owing, along with the interest due, but the DOR shall waive all late-payment penalties.

Ordered August 30, 2018.



David L. McAlpin, Chairman
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BOARD



Stephen A. Doherty, Member
MONTANA TAX APPEAL
BOARD



Valerie A. Balukas, Member
MONTANA TAX APPEAL
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Notice: You may be entitled to judicial review of this Order by filing a petition in district court within 60 days of the service of this Order. Mont. Code Ann. § 15-2-303(2).

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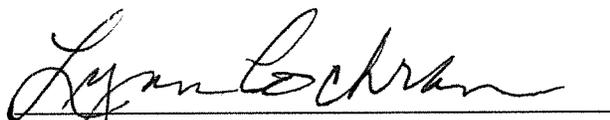
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Certificate of Service

I certify that I caused a true and correct copy of the foregoing *Findings of Fact, Conclusions of Law, and Opportunity for Judicial Review* to be sent by United States Mail via Print and Mail Services Bureau of the State of Montana on August 30, 2018 to:

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