

BEFORE THE MONTANA TAX APPEAL BOARD

Ronald and Natalie Melvin,

Appellants;

v.

**State of Montana,
Department of Revenue,**

Respondent.

CASE No: IT-2015-1

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

This case comes to this Board through a direct appeal of the Taxpayers Ronald and Natalie Melvin from an adverse decision of the Department of Revenue (hereinafter "Department" or "DOR").

Statement of Case

Taxpayers filed Montana individual income tax returns for the years 2008, 2009, 2010, 2011, in March of 2013. In July 2014 the Department initiated an audit of Taxpayers 2009-2013 returns. The Department issued tentative audit adjustments in September 2014, which included an adjustment to Taxpayers' 2008 return. Taxpayers failed to respond to the

tentative audit report within a 30-day deadline, and the Department closed the audit in November of 2014 imposing additional taxes, interest and penalties for years 2008-2012. In early February 2015, Taxpayer submitted amended returns to the Department for the 2008-2012 tax years. The Department refused to accept and process the amended returns on the grounds that Taxpayers had exhausted their administrative remedies for those years when the audit was closed in November of 2014. Taxpayers appealed the Department's decision to reject the amended returns to this Board pursuant to Mont. Code Ann. § 15-30-2607.

Issue

The issue before this Board is whether the Department should accept Taxpayers' amended Montana individual income tax returns for the years 2008 through 2012.

Findings of Fact

1. Due, proper and sufficient notice was given of this matter, and of the time and place of the hearing. All parties appeared for the hearing before this Board on October 8, 2015, and were afforded an opportunity to present oral and documentary evidence along with post-hearing briefs.

2. Taxpayers Ronald and Natalie Melvin reside in Polson, Montana.
During the years at issue in this appeal, 2008-2013, Ronald Melvin was self-employed as a contractor and Natalie Melvin earned wages from employment with the Confederated Salish & Kootenai Tribe. (MTAB Hrg. Transcr. 52:3-10.)
3. Mr. Melvin testified that they timely prepared and filed their 2007 return. (MTAB Hrg. Transcr. 10:20-24.) In 2008, when the housing market crashed in Polson, he had four houses under construction with \$780,000 in debt to different banks. (MTAB Hrg. Transcr. 9:7-10.)
When the 2008 return was due, several of the properties were in foreclosure. (Id. 11:1-13.) Mr. Melvin testified that he was uncertain how to report the debt until the banks actually sold the properties. (Id.)
Ultimately, the banks were able to sell the properties in excess of the debt owed and Mr. Melvin reported cancellation of debt income generated by a Bank of America credit card debt that was written off.
(Id.)
4. The Department received the Melvins' Montana individual income tax returns for the years 2008 through 2011 on March 21, 2013. (Ex. L.)
5. On July 14, 2014, the Department sent Taxpayers a letter notifying them that the Department was auditing Taxpayers' 2009-2013 returns. (Ex. 1.) The letter scheduled a tentative audit appointment on August

12 in the Department's Polson field office. (Id.) The letter requested Taxpayers bring documentation to support their Federal Form Schedule C deductions (Profit or Loss from Business for Federal Form 1040) for 2008-2012 to that meeting. (Id.)

6. On August 11, 2014, Mr. Melvin met with Sylvia Headley, a Department field auditor, in the Department's Polson office. Mr. Melvin answered Ms. Headley's questions and together they went through his documentation for each year under audit. (MTAB Hrg. Transcr. 5:20-15.) During that meeting, Ms. Headley explained many aspects of how to report various items of income and associated losses that Mr. Melvin had not previously understood at the time he prepared the returns. (Id. 8:13-16.)
7. On September 16, 2014, Ms. Headley issued a tentative audit report that asked the Taxpayers to review and respond back to her before October 15, 2014 with any corrections, revisions, etc. (Ex. M.) Mr. Melvin testified that he reviewed the tentative audit report and had numerous objections to the audit findings. (MTAB Hrg. Transcr. 6:3-11.) Mr. Melvin testified that the report expanded the years under audit to include 2008 wherein Ms. Headley characterized two independent buy/sell agreements as an I.R.C. §1031 exchange. (MTAB Hrg. Transcr. 6:6-9, 12:15-25.) Ms. Headley's characterization of those

transactions as a §1031 exchange resulted in an audit adjustment of \$100,000 in additional income to Mr. Melvin's 2008 Schedule C. (Ex. G.)

8. After reviewing the worksheets attached to the tentative audit report, Mr. Melvin objected to the Department's characterization of the two 2008 sales as a §1031 exchange (MTAB Hrg. Transcr. 12:13-25, 13:1-16) as well as recognizing that he had incorrectly calculated carry forward losses on his original returns. (MTAB Hrg. Transcr. 9:21-25, 10:1-13.) Mr. Melvin decided that he needed to prepare amended returns that would be more accurate than the original returns. (Id. 6:9-11.) Mr. Melvin testified that his motivation for preparing amended returns was the audit's inclusion of \$100,000 in additional income for tax year 2008, a year that had not been included in the original audit notice, along with his newly acquired knowledge regarding how to carry forward losses. (MTAB Hrg. Transcr. 6:4-11, 8:13-25, 9:21-25, 10:1-13.)
9. Ms. Headley testified that Mr. Melvin did not respond to either the tentative or final audit report within the prescribed 30 days or otherwise contact Ms. Headley to let her know that he was preparing amended returns. (MTAB Hrg. Transcr. 23:1-8.) On October 24, 2014, Ms. Headley issued a final audit adjustment letter that made the tentative adjustments to Taxpayers' tax liability final for tax years 2008 through 2012. (Ex. F.) The final audit adjustment letter stated

that Taxpayers had until November 23, 2014, to file written objections otherwise they would lose their right to appeal the Department's audit adjustments. (Id.) Nothing in the letter notified the Taxpayers that they would also lose their right to file amended returns for statutorily open years. (Id.)

10. Mr. Melvin testified that in order to prepare an amended return for 2008 he had to first amend 2007 to account for carry forward losses. (MTAB Hrg. Transcr. 6:9-11.) He testified that he needed to obtain copies of the real estate closing settlement statements to document that the two 2008 buy/sell agreements identified by Ms. Headley were not actually part of a §1031 exchange. (MTAB Hrg. Transcr. 10:22-24, 11:1-13.) Mr. Melvin testified that he worked diligently to prepare the amended returns using information he had learned during the audit and from the tentative audit worksheets, but that they still took him several months to complete due to their complexity and the number of years involved. (Id. 8:7-25.)
11. On December 17, 2014, Mr. Melvin sent Ms. Headley a cover letter with copies of the 2008 Real Estate Closing statements for the two buy/sell agreements that she characterized in the audit as a §1031 exchange and Mr. Melvin testified were not actually part of a §1031 exchange. (Ex. G.)

12. Ms. Headley did not respond to Mr. Melvin's December letter or otherwise notify him that she had closed the audit and their account was now in collections. (MTAB Hrg. Transcr. 28:14-23.)
13. On January 5, 2015, Ashley Allen, a lead collections technician for the Department, called Mr. Melvin. (MTAB Hrg. Transcr. 46:7-8.) During that conversation Mr. Melvin told her he had some issues with the audit and had sent in some paperwork but had not heard back from the Department. (Id. 46:13-14.) Ms. Ashley told Mr. Melvin that she would check with the auditor and give him a call back. (Id. 46:15-16.) At no time during the phone conversation did Ms. Allen identify to Mr. Melvin that she was working on collections. (Id. at 47:11-13.)
14. On February 8, 2015, Mr. Melvin mailed amended returns for 2008 through 2011 to Ms. Headley along with a copy of the first page of his amended Schedule C for 2007. (Ex. G; MTAB Hrg. Transcr. 24-25.) A cover letter from Mr. Melvin accompanying these amended returns states that total losses for 2007 Schedule C were adjusted and the carry forward for Schedule D remains the same. (Ex. G.)
15. Mr. Melvin testified that the amended returns made substantial changes to items on the original returns including adjustments to items that were not included or revised during the audit, and changes to the 2007 return. (MTAB Hrg. Transcr. 56-58.)

16. On February 10, 2015, Ms. Allen called Mr. Melvin, again she never identified that she was working on collections, instead she stated that she was just checking in. (Ex. O.) Mr. Melvin described that he was in the middle of amending all of the returns, working his way forward from 2007 to 2013, and that he was making progress in getting the amended returns completed. (Id.) Ms. Allen concluded the call by stating she would check back in with Mr. Melvin in another 30 days. (Id.)
17. On March 6, 2015, Mr. Melvin sent Ms. Headley their amended 2012 return along with a cover letter explaining which lines of the return he had amended. (Ex. J; MTAB Hrg. Transcr. 26:1-15.)
18. On March 3, 2015, Doug Peterson, Ms. Headley's supervisor, sent Taxpayers a letter stating that the Department was rejecting Taxpayers' amended returns for 2008 through 2012, without review, for failing to file any written objections within the 30-day appeal period triggered by Ms. Headley's October 24, 2014 letter. (Ex. I; MTAB Hrg. Transcr. 30:19-23.) The letter stated that the Taxpayers could appeal the Department's decision to reject the amended returns to this Board pursuant to Mont. Code Ann. §15-30-2607. (Ex. I.)
19. Mr. Peterson testified that normally a taxpayer can file an amended return within the five-year statute of limitation if there has not been an

audit. (MTAB Hrg. Transcr. 39:20-21.) In addition, a taxpayer may file an amended return for a closed year if there are net operating losses that carry forward to an open year. (Id. 40:17-25, 41:1-4.)

20. However, it is the Department's policy to reject amended returns for open tax years if the Department has closed an audit of those years, unless the amended returns change items that were not part of the audit. (Id. 41:14-15.) Mr. Peterson described a vague process for how the Department determines whether amended returns adjust items not previously included in an audit. (Id. 41:5-24, 42:1-25, 43:1-25.) Mr. Peterson testified as follows: "If the audit issue, in essence what the Department is saying is if the audit, the Taxpayer can't come in and reverse the audit issue after the audit is closed and after the appeal process has run. If the Taxpayer has a separate issue that is not part of the original audit the statute would be normally held open." (Id. 43:1-6). In response to a question from the Board as to what the Department's authority for this position is, Mr. Peterson testified "[j]ust interpretation of prior hearings and legal interpretation that the Department has from, from its attorneys." (Id. 43:17-19.) The Department's position was set forth in Mr. Peterson's letter as follows: "If the Department revises a filed return under the authority provided in Montana Code Annotated §15-30-205(3), the taxpayer is entitled to

'revise the same until the liability for that tax year is finally determined.' However, the liability is considered 'finally determined' in absence of any timely objection." (Ex. I.)

21. The Melvins timely filed an appeal of the Department's decision to reject the amended 2008-2012 returns, without review, to this Board.

CONCLUSIONS OF LAW

22. The Board has jurisdiction over this appeal. Mont. Code. Ann. § 15-30-2607.
23. To whatever extent the foregoing Findings of Fact may be construed as Conclusions of Law, they are incorporated accordingly.
24. The Montana Department of Revenue is an agency of the executive branch of government, created and existing under the authority of Montana Code Annotated, Title 2, Chapter 15, part 13. The Department is charged with the administration and enforcement of Montana's Individual Income Tax. Mont. Code Ann., Title 15, chapter 30 (Individual Income Tax) and the ancillary Administrative Rules of Montana, Title 42, chapter 15.
25. If, in the opinion of the Department, any return of a taxpayer is in an essential respect incorrect, it may revise the return. Mont. Code Ann. § 15-30-2605(1). The amount of tax due under any return may be determined by the Department within 5 years after the return was filed, regardless of whether the return was filed on or after the last day prescribed for filing. Mont. Code Ann. § 15-30-2605(3) (2013). 2
26. This Board concludes that the Department properly exercised its authority to audit and adjust the Melvins 2008-2012 returns. Although

² The 2015 Legislature amended this section from 5 years to 3 years.

the original audit notice did not include the 2008 tax year, the Department expanded the audit to include significant adjustments to 2008 after examination of Taxpayer's records. The Department has statutory authority to audit any return within five years after the return was filed. Taxpayers filed their 2008 return on March 21, 2013, and the Department issued its tentative audit report on September 16, 2014, well within the Department's five year statute of limitation.

27. The Department relies on Mont. Code Ann. § 15-30-2607 to support its position to reject Taxpayers amended returns.

An application for revision may be filed with the department by a taxpayer within 5 years from the last day prescribed for filing the return as provided in 15-30-2605(3), regardless of whether the return was filed on or after the last day prescribed for filing. If the department has revised a return pursuant to 15-30-2605(3), the taxpayer may revise the same return until the liability for that tax year is finally determined. If the taxpayer is not satisfied with the action taken by the department, the taxpayer may appeal to the state tax appeal board.

Mont. Code Ann. §15-30-2607.3

28. The Department interprets the words "finally determined" in the second sentence of this statute to mean closed an audit. Thus, the Department rejected Melvins' amended returns on the grounds that they exhausted their administrative remedies to amend any items under audit on their 2008-2012 returns when they failed to respond

³ The 2015 Legislature amended the 5 years to 3 years.

within 30 days of Ms. Headley's final audit letter dated October 24, 2014. Mr. Peterson testified that the Department would have accepted amended returns for these years if the amended returns raised a separate issue that was not part of the original audit. However, the Department never actually processed the Melvins' amended returns to determine whether or not the amended returns simply reversed the audit findings or made new adjustments not previously determined by the audit.

29. The Board concludes that Mr. Melvin testified credibly when he stated that the adjustments in the amended returns do not simply reverse the Department's audit findings, but raise new issues and items that were not part of the audit determination. The evidence in the record supports the Board's conclusion that the Department conducted a summary and cursory review of the Melvins' amended returns and rejected them whole cloth for failure to raise issues not resolved by audit. The evidence in the record shows that the Department acted arbitrarily when it rejected Melvins' amended returns without taking the time to process and examine whether or not the adjustments were actually duplicative and therefore served only to reverse the audit findings. Certainly, at a minimum the Department did not introduce sufficient evidence to support its position that the amended returns

served no purpose other than to reverse the audit findings. The Department did not provide this Board with copies of the Melvins' original and amended tax returns that arguably might have corroborated the Department's position in this case.

30. The Board also concludes that Mr. Melvin worked diligently to prepare the amended returns and notes that he first contacted Ms. Headley on December 17, 2014, within 3 weeks of when the Department considered the audit closed. Between December 17th and February 8, 2015, the date when Mr. Melvin filed the amended returns, he reasonably believed that the Department was aware that he was in the process of preparing amended returns and never notified him that it was too late to do so. His contacts with both Ms. Headley and Ms. Allen, to a reasonable person, meant that the Department was going to accept the amended returns. He rightly assumed that if the issue was finalized the DOR would have said as much.

31. The Board recognizes the Department has a legitimate concern that a taxpayer should not be allowed to ignore an audit and then effectively reverse the audit findings by filing amended returns. There is however already a significant disincentive for taxpayers who fail to participate in the audit process – so long as the Department complies with its notice requirements, it can unilaterally assess additional taxes owing,

interest and penalties, Mont. Admin. R. 42.15.325, after which it can issue a warrant of distraint to start collection activities, which include garnishing wages, levying bank accounts and placing liens any real property owned by the taxpayer, Mont. Code Ann. §15-1-702. Thus, the deadlines set forth in the Department's administrative audit process are not meaningless.

32. The Board finds that Mr. Melvin's credible testimony supports a conclusion that he did not file amended returns to simply reverse the audit findings, but rather in an honest and good faith attempt to more accurately report his income, which do have complicated issues for an individual with no particular training in tax preparation. An amended return allows a taxpayer to correct mistakes on a return already filed. The Legislature, by passage of §15-30-2607, granted taxpayers the ability to file amended returns and gave taxpayers the same five year window to file amended returns that it granted the Department to audit returns.

33. The Department's interpretation of the second sentence of Mont. Code Ann. § 15-30-2607 does not comport with a plain reading of the statute. "If the department has revised a return pursuant to 15-30-2605(3) [the Department's audit authority], the taxpayer may revise the same return until the liability for that tax year is finally determined." The

Department interprets this sentence to mean that once they have audited a return a taxpayer loses their right to file an amended return. Accepting this interpretation would render the Legislature's grant of five years to file an amended return meaningless.

34. "The 'public policy' of the state is for the law-making power of the state to declare. The state has no 'public policy' except that found in its Constitution and Laws, which are made by the law-making power and not by administrative officers acting solely on their own ideas of public policy in promulgating a rule or so-called 'regulation.'" *State ex rel. McCarten v. Corwin*, 119 Mont. 520, 529, 177 P.2d 189, 194 (1947).
35. "Administrative agencies enjoy only those powers specifically conferred upon them by the legislature. Administrative rules must be strictly confined within the applicable legislative guidelines. Indeed, it is axiomatic in Montana law that a statute cannot be changed by administrative regulation. We look to the statutes to determine whether there is a legislative grant of authority." *Bick v. State, Dep't of Justice, Div. of Motor Vehicles*, 224 Mont. 455, 457, 730 P.2d 418, 420 (1986).
36. The Legislature has stated that any taxpayer has the right to file amended returns within 5 years of the return's due date, and specifically directs that even if the Department has audited a return,

the taxpayer may revise the same return until the liability for that tax year is finally determined. Mont. Code Ann. §15-30-2607. This Board interprets the words “finally determined” to mean the running of the five-year statute of limitation as set forth by the Legislature in the preceding sentence of the statute or the conclusion of a final adjudicative determination of the tax due as determined through the exhaustion of judicial remedies not the conclusion of an administrative audit. This Board’s interpretation mirrors the federal tax procedures as set forth in 26 U.S.C. §7481, and comports with a finding that internal deadlines created by an agency for purposes of its own administrative processes cannot supersede and significantly shorten the Legislature’s grant of time set forth in a specific statute of limitation.

1. One question unresolved by the evidence in the record is whether Mr. Melvin timely filed the amended 2008 return. However, a taxpayer may file amended returns for closed years if it amends net operating losses that can be carry forwarded to years that are still open. Mont. Code Ann. § 15-31-119. According to Mr. Melvin’s credible testimony that is specifically what his amended 2008 return would do if he is allowed to file it.

Order

IT IS THEREFORE ORDERED by the Montana Tax Appeal Board that the Department accept and process Taxpayers' amended individual income tax returns for the years 2008-2012.

DATED this 3rd day of March 2016.

BY ORDER OF THE MONTANA
TAX APPEAL BOARD

(SEAL)



DAVID L. McALPIN, Chairman



STEPHEN A. DOHERTY, Member



VALERIE A. BALUKAS, Member


Notice: You may be entitled to judicial review of this Order in accordance with Mont. Code Ann. § 15-2-303(2). Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 3rd day of March, 2016, the foregoing Order to be sent by United States Mail via Print and Mail Services Bureau of the State of Montana, to:

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