

FRANKLIN & JANET TIEGS,

Appellant,

v.

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

Respondent.

CASE №: **IT-2019-20**

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

STATEMENT OF THE CASE

Under the authority of Mont. Code Ann. § 15-2-302, this is a direct appeal from the Montana Department of Revenue Office of Dispute Resolution (ODR), where a hearing was held on April 26, 2019 and the ODR Final Decision issued on September 26, 2019. The ODR upheld the DOR’s final audit determination. The main contentions at ODR were first whether the income generated by Baker through its equipment leases to Jore is nonbusiness income; and second, how the income should be reported under Mont. Code. Ann. § 15-31-301 and Mont. Admin. R. 42.26.206.

ISSUE TO BE DECIDED

The issues have been narrowed by stipulations of the parties and the only reaming issue on appeal is whether the Tiegs, as nonresident taxpayers with Montana source losses, but no federal net operating loss, can carry forward those losses to offset Montana Source income in subsequent years.

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EXHIBITS

The Board admitted the exhibits the parties included in their March 20, 2020 Joint Stipulation of Exhibits, which were also submitted to the ODR before their April 6, 2019 hearing on this matter. The exhibit list includes Taxpayers' Exhibits 1-4, Department Exhibits A-N (Tiegs), and Department Exhibits AA-NN (Baker).

FINDINGS OF FACT

The facts in this matter are undisputed as provided in the parties' February 28, 2020 Joint Stipulation of Fact and Issue.

1. Franklin and Janet Tiegs are not Montana residents. They report their Montana source income as non-resident taxpayers.
2. Baker Produce Inc. is a Washington corporation wholly owned by Franklin Tiegs and treated, by election, as an S corporation. As a result, income derived from Baker's activities is passed through and reported on Mr. and Mrs. Tiegs' individual income tax return.
3. Baker processes, packages, and sells potatoes and fruit from various farm entities. Baker also has an apple orchard business, all located in Washington State. Baker has no agricultural operations in Montana.
4. Jore is a Delaware corporation owned by Franklin Tiegs and operating in Montana. It designs, manufactures, and markets power tool accessories and hand tools. Jore also elected to be treated as an S corporation. As a result, income derived from Jore's

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activities is passed through and reported on Mr. and Mrs. Tiegs' individual income tax return.

5. In 2009 Baker purchased certain operating equipment from Jore. The operating equipment was and continues to be located within Montana. Following the purchase, Baker began to depreciate the equipment and leased it back to Jore (Jore Lease).
6. Between 2009 and 2015, representatives for Baker consistently reported the income generated by the Jore Lease as nonbusiness income.
7. During that time Baker representatives repeatedly advised the Department that:

[e]quipment leasing is not the normal course of business for Baker. It is in the business of packaging and selling agriculture products and owns and operates orchards. The Jore manufacturing equipment acquired in 2009 has no relation to these agricultural activities.
8. Baker also advised the Department that:

Baker's only activity in Montana is the leasing of manufacturing equipment to Jore. It has no other activity in Montana, and equipment leasing is not its normal business activity.
9. Between 2009 and 2013, Baker reported Montana source losses resulting from the depreciation of the leased equipment and Jore reported Montana source income.
10. The losses generated by Baker offset the income generated by Jore and, because the Baker losses were larger than the Jore income, the result each year was a net Montana source loss reported by the Tiegs.

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11. The Montana source losses were properly reported, from 2009 to 2013, on Line 11 of the Tiegs' Montana Individual Income Tax Return Form 2, Schedule IV, where Montana source S corporation income or losses are to be reported.

12. In 2014 and 2015, Baker and Jore had Montana source income.

13. The Tiegs did not report Montana source income in 2014 and 2015 from Baker and Jore on Line 11 as the prior year's Montana source losses had been reported; instead nothing was reported on Line 11 for these years because Baker and Jore carried forward Montana source losses from 2009 through 2013 to offset Montana source income received in 2014 and 2015.

14. The Department audited The Tiegs' 2014 and 2015 returns and disallowed the deductions of Montana source losses claimed by Baker as net operating losses (NOLs).

15. In response to the denied deductions, Baker filed amended S corporation returns recharacterizing the 2014 through 2015 income that was previously allocated nonbusiness income as apportionable business income.

16. The Department audited Baker's amended returns and determined the income and losses from the Jore Lease were not apportionable business income as Baker had previously submitted on more than one occasion that Baker

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business activity did not include leasing of manufacturing equipment and therefore under Montana Law was not appropriable business income.

17. Baker and Tiegs have since conceded that the income and losses from the Jore Lease for 2009 through 2015 were not apportionable.
18. The Tiegs have not been denied "any state deduction" for their losses. They received a deduction or a full offset of their Montana income tax in each year they claimed a loss from 2009-2013. Each year a loss was reported, as clearly required by statute, it was included in both the numerator (Montana source income) and the denominator (total income from all sources) used in the ratio to calculate their tax liability. Under Montana law, there is no authority to recharacterize or recycle a loss and use it again elsewhere or in another tax year and a prohibition under Mont. Code Ann. § 15-30-2104, on counting it more than once in determining the amount of Montana source income.
19. Taxpayers' position is that the Department's audit findings constitute an indirect tax on income from outside Montana. Following Mont. Code Ann. § 15-30-2104, after applying the progressive tax table, the nonresident ratio is used to reduce the resident tax to the fraction that is attributable to the Montana source income included in taxable income. Using property not itself taxable in this manner as a measure of the tax imposed on property within the state is "in no just sense a tax on foreign property" and does not deny taxpayers of due process. *Stevens v. State Tax Assessor*, 571 A.2d 1195, 1197, 1990 Me. LEXIS 95 (citing *United States v. Kansas*, 810 F.2d 935 (10th Cir. 1987)).

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20. Taxpayers' contends the Department's audit results in a higher tax for those with income outside of Montana. The Department counters, though the Teigs may pay more Montana income tax on their Montana source income than a Montana resident whose total income equals their Montana source income, there is no facial discrimination because similarly situated residents and nonresidents are taxed at an equal rate.
21. In addressing a constitutional challenge to a statute, the statute is presumed to be constitutional and the challenging party has the burden of establishing the statute's unconstitutionality. *GBN, Inc. v Dep't of Revenue*, 249 Mont. 261,265, 815 P.2d 595, 597, 48 Mont. St. Rep. 715 (1991). If a doubt exists, it is to be resolved in favor of the legislation. *Id.*
22. The Department is charged with the administration and enforcement of the Montana Code Annotated, Title 15. This includes Chapter I, Tax Administration, which incorporates the Multistate Tax Compact, and Chapter 30, Individual Income Tax (Chapter 30). The Department is also responsible for administering and enforcing the ancillary rules, found in Administrative Rules of Montana, Title 42, Chapter 15.
23. To whatever extent the foregoing findings of fact may be construed as conclusions of law, they are incorporated accordingly.

JURISDICTION AND STANDARD OF REVIEW

24. The Montana Tax Appeal Board is an independent entity not affiliated with the Montana Department of Revenue. Under the authority of Mont. Code Ann. § 15-2-301.

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25. The Taxpayer filed a timely appeal to the MTAB. Therefore, this Board has jurisdiction to hear and decide this matter. Mont. Code Ann. §15-2-302.
26. While the parties here have stipulated to relevant facts and a single legal issue which Taxpayers allege raises constitutional concerns, the primary matter is whether the Department's position and interpretation of the underlying statutes and rules is correct. Thus, the matter is properly before the Board.
27. This appeal is governed by the contested case provision of the Montana Administrative Procedure Act. Mont. Code Ann. § 15-2-302(5)

CONCLUSIONS OF LAW

28. To whatever extent the following conclusions of law may be construed as findings of fact, they are incorporated accordingly.
29. The DOR is an agency of the executive branch of government created and existing under the authority of Mont. Code Ann. § 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 and the Multistate State Tax Compact.
30. "If, in the opinion of the department, any return of a taxpayer is in any essential respect incorrect, it may revise the return." Mont. Code Ann. §15-30-2605(1).
31. "Taxable income' means the adjusted gross income of a taxpayer less the deductions and exemptions provided for in this chapter." Mont. Code Ann. §15-30-2101(32).

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32. “[G]ross income means all income from whatever source derived, including (but not limited to) ... [c]ompensation for services, including fees, commissions” 26 U.S.C. §61.
33. “[A]djusted gross income is the taxpayer’s federal adjusted gross income as defined in section 62 of the Internal Revenue Code, 26 U.S.C. 62,” and includes certain additions. Mont. Code Ann. §15-30-2110(1).
34. “Under Montana law, in computing net income, deductions are generally those permitted by 26 U.S.C. §161 and 211. Mont. Code Ann. § 15-30-2131(1)(a).” *Robinson v. DOR*, 2012 MT 145, ¶ 3, 365 Mont. 336, 336, 281 P. 3d 218, 218.
35. “Tax deductions are a matter of legislative grace, and it is the taxpayer’s burden to clearly demonstrate the right to the claimed deduction.” *Robinson v. DOR*, 2012 MT 145, ¶12, 265 Mont. 336, 340, 281 P. 3d 218, 222 (Quoting *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992)).
36. The taxpayer bears the burden of proving the error of DOR’s decision. *Farmers Union Cent. Exch., Inc. v. Dep’t of Revenue of State of Mont.*, 272 Mont. 471, 476, 901 P.2d 561, 564 (1995); *Western Air Lines, Inc. v. Michunovich*, 149 Mont. 347, 353, 428 P.2d 3, 7 (1967).
37. DOR is entitled to a “presumption of correctness if its decisions are pursuant to an administrative rule or regulation, and the rule or regulation is not arbitrary, capricious or otherwise unlawful.” *Dep’t of Revenue v. Burlington N. Inc.*, 169 Mont. 202, 214, 545 P.2d 1083, 1090 (1976). However, DOR cannot rely entirely on the presumption in its favor and

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must present a modicum of evidence showing the propriety of their action. *Western Air Lines*, 149 Mont. at 353, 428 P.2d at 7.

38. The taxpayer bears the burden of proving the error of DOR's decision. *Farmers Union Cent. Exch., Inc. v. Dep't of Revenue of State of Mont.*, 272 Mont. 471, 476, 901 P.2d 561, 564 (1995); *Western Air Lines, Inc. v. Michunovich*, 149 Mont. 347, 353, 428 P.2d 3, 7 (1967).
39. When construing a statute, it is the Board's role to "determine what in terms or substance is contained in it, and not to insert what has been omitted or to omit what has been inserted." *State v. Minett*, 2014 MT 225, ¶ 12, 376 Mont. 260, 332 P.3d 235; Mont. Code Ann. § 1-2-101.
40. In the construction of a statute, the intention of the legislature is to be pursued if possible. When a general and particular provision are inconsistent, the latter is paramount to the former, so a particular intent will control a general one that is inconsistent with it." Mont. Code Ann. § 1-2-102.
41. "When faced with a problem of statutory construction great deference must be shown to the interpretation given the statute by the officers or agency charged with its administration." *Dep't of Revenue v. Puget Sound Power & Light Co.*, 179 Mont. 255, 262, 587 P.2d 1282, 1286 (1978) (citing *Udall v. Tallman*, 380 U.S. 1, 16 (1965)).
42. "When a taxing statute is susceptible to two constructions, doubt should be resolved in favor of the taxpayer....[T]ax statutes are to be strictly construed against the taxing

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authority and in favor of the taxpayer.” *Western Energy Co. v. State, Dep't of Revenue*, 1999 MT 289, ¶ 10, 297 Mont. 55, 990 P.2d 767.

43. However, the rules of statutory construction require the language of a statute to be first construed according to its plain meaning; if the language is clear and unambiguous, the court may not look beyond this and apply other means of interpretation. *Lucas Ranch, Inv. v. Mont. Dep't of Revenue*, 2015 MT 115, ¶ 21, 379 Mont. 28, 347 P.3d 1249. See also, *State v. Wolf*, 2020 MT 24, ¶ 15, 398 Mont. 403, 457 P.3d 218 (citing *State v. Gatts*, 279 Mont. 42, 47, 928 P.2d 114, 117 (1996)).
44. “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).
45. “A valid and enforceable agency rule cannot exceed its enabling statute....” *Glendive Med. Ctr., Inc. v. Montana Dep't of Pub. Health & Human Servs.*, 2002 MT 131, ¶ 29, 310 Mont. 156, 49 P.3d 560.
46. “[A]dministrative regulations interpreting the statute made by agencies charged with the execution of the statute are entitled to respectful consideration.” *Dep't of Revenue v. Puget Sound Power & Light Co.*, 179 Mont. 255, 266, 587 P.2d 1282, 1288 (1978).

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47. The Board “may not amend or repeal any administrative rule of the department,” but may enjoin its application if the Board concludes the rule is “arbitrary, capricious, or otherwise unlawful.” Mont. Code Ann. § 15-2-301.
48. The statutes and rules in effect in tax years 2014 - 2015 govern this matter.
49. If, in the opinion of the Department, a return of a taxpayer is in any essential respect incorrect, the agency may revise the return. Mont. Code Ann. § 15-30-2605(1).
50. Baker and Jore are S corporations, which are pass-through entities, the income and losses of which pass through to the Tiegs. Mont. Code Ann. § 15-30-2101(24), 15-30-3301, and 15-30- 3311(2). S corporations are required to file annual informational returns but pay no income tax - their income and deductions are allocated and passed through to their shareholders. Mont. Code Ann. § 15-30-2101(24) and 15-30-3302. Consequently, Baker and Jore have no ability to recognize net operating losses; these may only be recognized by the shareholders.
51. Franklin Tiegs, as the sole shareholder of these two entities, pays tax in Montana based on the Montana source income the Tiegs recognize from Baker and Jore each tax year. Mont. Code Ann. § 15-30- 3311.
52. The subject Montana income and losses are non-apportionable income and losses which are properly allocated to Montana and constitute Montana source income. Mont. Code Ann. § 15-1-601, Article IV(5) and 15-30-2101(18)(a)(xiii).

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53. All income and losses from all sources, for residents and nonresidents alike, must be reported on the Montana Individual Income Tax Return, Form 2. Mont. Code Ann. § 15-30-2102; ARMs 42.15.108 and 42.15.110. Nonresidents must also report their Montana source income on Form 2, Schedule IV, Line 11 (Line 11) for the calculation of the nonresident tax. *Id.*
54. The Tiegs were required to continue reporting their Montana S corporation income on Line 11 in 2014 and 2015, just as they had reported their Montana S corporation losses on Line 11 between 2009 and 2013. *Id.*
55. The failure to report their income on Line 11 in 2014 and 2015 (Department Ex. A, Tiegs- DOR 205 and 21A0) was a violation of the filing requirements and resulted in a substantial understatement of the Tiegs tax liability for 2014 and 2015. *Department Ex. F, Tiegs-DOR 276-286.*
56. When they reported their Montana source loss each year from 2009-2013, the loss was included or counted each year in both total income from all sources and Montana source income. There is no authority to report it elsewhere, nor any basis in existing Montana law for counting the loss again, or carrying it over to another tax year. Mont. Code Ann. § 15-30-2104.
57. The loss resulting from the depreciation of the asset leased between related entities was recognized in each of these years from 2009-2013; the Tiegs benefited from no Montana tax liability as shown on the last line of their Schedule IV for each year. *Department Ex. A, Tiegs-DOR 216, 222, 229, 235, and 239.*

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58. Taxpayers' sudden change in practice reporting previously recognized Montana source losses on their S corporation informational returns and attempting to characterize those prior losses as NOLs used to offset Montana source income on their individual income tax returns for 2014 and 2015 violates taxpayers' duty of consistency in reporting, did not coincide with a relevant change in law or filing instructions, and is contrary to Montana tax code.
59. Taxpayers maintain the Department has authority under the Multistate Tax Compact (MTC) to employ an alternative method to determine their Montana tax liability. However, the relief they seek under the MTC is limited to use of an "other method to effectuate an equitable allocation and apportionment of the taxpayer's income" in the event "the allocation and apportionment provisions of this article do not fairly represent the extent of the taxpayer's business activity in this state". Mont. Code Ann. § 15-1-601, Article IV (18), MCA.
60. Taxpayers have conceded the subject income is allocated or non-apportionable income under Article IV of the MTC as adopted in Mont. Code Ann. § 15-1-601. *Finding, 18.* Accordingly, the relief they seek in requesting the Department grant the Tiegas a deduction on their individual income tax returns based on an NOL calculated outside the terms of the NOL statute in Mont. Code Ann. § 15-30-2119, is beyond the scope of the relief provided in the MTC.
61. Taxpayers do not dispute how Montana determines the calculation of income tax for nonresidents under Mont. Code Ann. § 15-30-2104. *Appellant's Reply Brief, p. 3.*

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62. The nonresident tax, which applies to nonresidents with Montana source income, is equal to the tax calculated at the rate specified for residents under Mont. Code Ann. § 15-30-2103, multiplied by the ratio of Montana source income to total income from all sources. Mont. Code Ann. § 15-30-2104 (emphasis added).
63. This calculation specifically prohibits any items of income, gain, loss, deduction, expense, or credit to be counted more than once in determining the amount of Montana source income. *Id.*
64. Individual states vary widely in their statutory construction and how NOL deductions are calculated and applied. Hellerstein and Hellerstein, *State Taxation* (Warren, Gorham & Lamont, 3rd ed. 2003) at 7.12, Deduction for Net Operating Losses (separating states' varying approaches to the NOL deduction by distinct categories).
65. Taxpayers cite to several jurisdictions as support for their position, while yet other jurisdictions cited by the Department are consistent with the Department's position. Nevertheless, the law in other jurisdictions cannot serve as the primary source for interpreting the Montana NOL provision and corresponding rules where Montana has its own rules of statutory construction and interpretation.
66. Mont. Code Ann. § 15-30-2119 provides no discretion to the Department in determining whether a taxpayer with a Montana NOL can recharacterize that into a future NOL.

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67. "Montana income tax deductions are a matter of legislative grace, and it is the taxpayer's burden to clearly demonstrate the right to a claimed deduction." *Robison v. Dep't of Revenue*, 2012 MT 145, ¶ 12, 365 Mont. 336, 281 P.3d 218. A deduction cannot be inferred or presumed; deductions are authorized only under clear statutory provisions. *Baitis v. Dep 't of Revenue*, 2004 MT 17, ¶ 25, 319 Mont. 292, 83 P.3d 1278.
68. Similarly, a "revenue statute allowing a deduction should be construed with specificity, as opposed to the rule of liberal construction which generally applies to revenue laws." *United Tote v. Dep't of Revenue*, 1993 Mont. Dist. LEXIS 384, *5 (Mont. Dist. Ct. 1993) citing *Cyprus Mines Corp. v. Madison County*, 172 Mont. 116, 118, 560 P.2d 1342, 343 (1977).
69. Mont. Code Ann. § 15-30-2119, provides that the calculation of a Montana NOL must be determined "in accordance with" the federal NOL statute, IRC § 172, which does not distinguish between source of income by state. Mont. Code Ann. § 15-30-2119, specifies further, that a Montana NOL means taxable income as defined in Mont. Code Ann. § 15-30-2101, computed with the IRC § 172(d) modifications as they relate to Chapter 30.
70. Taxable income is defined in Mont. Code Ann. § 15-30-2101(32), "as the adjusted gross income (AGI) of a taxpayer less the deductions and exemptions provided for in this chapter [30]."

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71. Taxpayers' argument fails for this reason: a Montana NOL is not based on Montana source income as they would have it, but AGI, which includes *both* Montana and non-Montana source income. Mont. Code Ann. § 15-30-2110.
72. Nothing contained within the plain language of Mont. Code Ann. § 15-30-2119, contemplates or authorizes tracking and reporting a Montana NOL solely based on Montana source income and losses as Taxpayers propose.
73. Had the legislature intended for a Montana NOL to start with Montana source income rather than the broader, defined "taxable income," the statute would have indicated as much. We cannot now insert what has been omitted nor omit what has been inserted into this statute, nor the companion administrative rule. Mont. Code Ann. § 1-2-101.
74. Like the NOL statute, ARM 42.15.318 cannot be construed to authorize, let alone require, the computation of a separate Montana source NOL for allocated Montana losses only. This rule provides that a taxpayer only has a Montana NOL if their Montana taxable income is less than zero; the Tiegs had positive Montana taxable income in 2014 and 2015. *Department Ex. A, Tiegs-DOR 202 and 207.*

CONCLUSION

75. The Taxpayers have failed to meet their burden to clearly demonstrate a statutory right to the NOL deduction they claim. No provision exists in Montana law to allow a taxpayer to carry forward Montana source losses to offset Montana source income in subsequent years independently from the determination of taxable income.

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76. The Board finds that Taxpayers have not proved error in the Department's audit.

77. We find no ambiguity in the provisions that govern this matter. The plain language is clear and not susceptible to alternate interpretation that should be resolved in Taxpayers' favor.

78. The Department correctly applied the statutes of Montana and Department Rules regarding the 2014-2015 audit and properly disallowed the previously claimed Montana source losses that Taxpayers carried forward on their tax returns because the losses did not constitute a Montana NOL under the applicable statutes and rules.

79. The Montana Legislature is free to pass a law allowing for this deduction, but to date has not done so. Until that time this Board is unable to confer this deduction on the Taxpayer without explicit authority granted by the Legislative branch of state government.

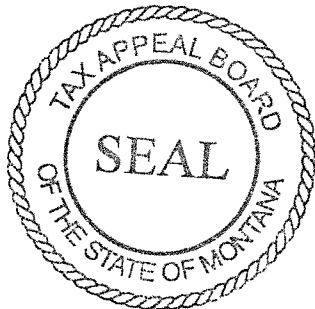
80. In light of the foregoing determinations of law, we find it unnecessary to reach a decision with regard to the Constitutional arguments raised by the Taxpayer.

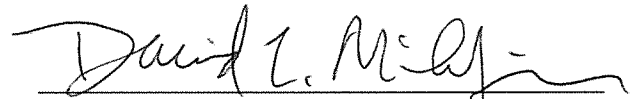
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ORDER


83. Taxpayers' Appeal is denied.
84. The findings of the Department's income tax audit and final agency decision for tax years 2014 and 2015 are upheld.
85. The income tax, penalties, and interest as assessed by the Department are due and owing.

Ordered November 25, 2020




David L. McAlpin, Chairman
MONTANA TAX APPEAL BOARD


Stephen A. Doherty, Member
MONTANA TAX APPEAL BOARD


Eric Stern, Member
MONTANA TAX APPEAL BOARD

Notice: You are entitled to judicial review of this Order by filing a petition in district court within 60 days of the service of this Order. The Department of Revenue shall promptly notify this Board of any judicial review to facilitate the timely transmission of the record to the reviewing court. MCA §15-2-303(2).

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Certificate of Service

I certify that I caused a true and correct copy of the foregoing *DOCUMENT* to be sent by United States Mail via Print, Email and Mail Services Bureau of the State of Montana on November 25, 2020 to:

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Lynn Cochran, Legal Secretary
MONTANA TAX APPEAL BOARD