

Before The Montana Tax Appeal Board

FILED

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Montana Tax Appeal Board

PURNAL WHITEHEAD,

Appellant,

v.

STATE OF MONTANA,

DEPARTMENT OF REVENUE,

Respondent.

CASE No: IT-2021-17

(Tax Years 2016 & 2017)

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

STATEMENT OF THE CASE

This is an appeal of a final decision by the Department of Revenue (DOR or Department) which affirmed the DOR's audit adjustments and calculation of tax, interest, and penalties due resulting from Purnal Whitehead's (Taxpayer) 2016 and 2017 income tax filings. After the final audit determination resulting in tax due, Taxpayer appealed to the DOR's Office of Dispute Resolution (ODR), which held a hearing on February 4 and 5, 2020. In its opinion and order, the ODR upheld DOR's determination and taxes, penalties and interest accruing. The Taxpayer appealed that outcome to the Montana Tax Appeal Board (MTAB) on June 2, 2021. We affirm DOR's determination.

ISSUE TO BE DECIDED

Mr. Whitehead disputes three audit revisions taken by the DOR: 1) taxation of his 1099-R distribution; 2) denial of his Simple, Qualified Plan (SEP) deductions; and 3) denial of his interest expense deduction.

EXHIBIT LIST

1. The following evidence was submitted for the appeal and hearing:

Department Exhibits:

- A. 2016 Original MT Tax Return -10 pages;

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

- B. 2016 Corrected MT Tax Return - 10 pages;
- C. 2016 Amended MT Tax Return – 8 pages;
- D. 2017 MT Tax Return;
- E. 7/16/19 MDOR Letter-Response for 2016-2017;
- F. 2016 form 1099-R;
- G. 2016 form 8606 – 2 pages;
- H. Post ODR 2016 form 5498 – 2 pages;
- I. Post ODR Addendum re: 5498 received;
- J. 12/28/2018 MDOR Adjustment letter 2017;
- K. 2016 Schedule K-1 from GIP;
- L. 2016 1040X Amended Fed Return – Form 4952;
- M. 2008 MT Tax Return;
- N. 2009 MT Tax Return;
- O. 2010 MT Tax Return;
- P. 2011 MT Tax Return;
- Q. 2012 MT Tax Return;
- R. 2013 MT Tax Return;
- S. 2014 MT Tax Return;
- T. 2015 MT Tax Return;
- U. 10/19/2021 Dismissal letter due to lack of jurisdiction.

Mr. Whitehead Exhibits:

- 1. MDOR 1/21/20 letter with notes for presentation;
- 2. Mr. Whitehead responses to above MDOR letter;
- 3. Closing remarks;
- 4. 3/31/2021 Updated response to Ms. Crepeau, Mr. Merrien and Mr. Olson;
- 5. 5/26/2021 References ODR's Final Decision with letter outlining 3 disputes;
- 6. 10/4/2019 Basis for objections for disputes A, B, C;

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

7. 8/6/2019 Reply to DOR-Mr. Merrien's letter 7/16/2019;
8. 6/26/2021 Refers to two letters (1/14/20 and 2/13/20) submitted after ODR telephone conference. Includes exhibits for each dispute;
9. 8/17/2021 sends letter to Ms. Crepeau, Mr. Olson and Mr. Merrien with response to initial report of 2/4/20 and clarification with more tax forms;
10. 8/26/2021 Addendum letter for missed exhibit of 2/13/20 to MTAB;
11. 5/8/2019 letter to Mr. Merrien with exhibits A – F;
12. 6/12/2019 letter to Mr. Merrien with additional requested information;
13. 2/13/2020 letter to Ms. Crepeau, Mr. Merrien, and Mr. Olson responding to the initial conference report held on 2/4/2020 with ODR;

PROCEDURAL HISTORY

The Taxpayer appealed to the Montana Tax Appeal Board (MTAB) on June 2, 2021, per Mont. Code Ann § 15-2-302. *MTAB Dkt. 1*. The MTAB hearing was conducted in Helena on October 26, 2021, at which the following were present:

- a. Teresa G. Whitney and Kristina K. Warren, DOR Counsel; Karolee Weickum, DOR Auditor; Brian Olsen and David Merrien, Field Audit Unit Managers; and
- b. Purnal D. Whitehead, Taxpayer.

The record includes all materials submitted to ODR, a transcript of the ODR hearing, all materials submitted to MTAB with the appeal, and additional exhibits submitted by the parties prior to and at the MTAB hearing.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

FINDINGS OF FACT¹

1. To whatever extent the foregoing findings of fact may be construed as conclusions of law, they are incorporated accordingly.
2. Mr. Whitehead filed his 2017 Montana Individual Income Tax Return (2017 Tax Return) on October 9, 2018. *Dept. Ex. D.*
3. Between May 2007 and October 2016, Mr. Whitehead was a member² of Glacier Investment Properties, LLC (GIP). *Taxpayer Ex. 5.* Mr. Whitehead made an initial capital contribution to the company of \$50,000 in exchange for 11.765%³ interest in the company. *Taxpayer Ex. 8.*
4. Mr. Whitehead refinanced his home in 2007, consolidating a \$120,000 line of credit from First National Bank with Countrywide Homes Loans creating a mortgage in the amount of \$289,000. *Taxpayer Ex. 8; MTAB Hrg. Transcr. 61:24-62:6.* He used \$50,000 of the original \$120,000 line of credit to fund his investment in GIP. *Taxpayer Ex. 9.*

¹ The history of the case was summarized in the ODR's Findings of Fact, Conclusions of Law, and Order, dated May 7, 2021. Because these facts were not repeated at the MTAB hearing, this opinion includes background information from the ODR hearing.

² In general, an owner of a partnership interest is a partner, while an owner of an LLC interest is a member (Mont. Code Ann. 35-8-102(21)). Because GIP was an LLC taxed as a partnership, the term "partnership" was commonly used throughout the hearing to refer to the LLC and the term "partner" was commonly used to refer to the owners of GIP.

³ The final K-1 issued by GIP indicates that Mr. Whitehead held 13.333% interest in the company's profits, losses, and capital throughout 2016, that the beginning balance of his capital account in 2016 was \$68,153, and that he received distributions totaling \$209,952 in 2016. DOR Exhibit K. Whether Mr. Whitehead held an 11.765% interest in GIP, or a 13.333% interest is not in itself relevant to this Board's analysis. These differences are acknowledged simply because of the difference between Taxpayer Exhibit 8 and DOR Exhibit K.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF REVENUE

5. Mr. Whitehead owns ETA Enterprises (ETA), a sole proprietorship. *MTAB Hrg. Transcr. 44:5-7; Taxpayer Ex. 8*. At all times relevant to this matter, ETA maintained what Mr. Whitehead referred to as a “rental account” with First Montana Bank. *ODR Ex. 6-C*.
6. Mr. Whitehead established his individual 401(k) through his business, ETA and filed the required adoption agreement with the IRS on April 1, 2011. *MTAB Hrg. Transcr. 44:15-46:3; ODR Ex. F*. He further testified in the hearing that he did not receive income from ETA. *MTAB Hrg. Transcr. 44:5-45:4*.
7. According to Mr. Whitehead, the ETA account was a place he could designate certain monies, but it was not, he testified in the ODR hearing, an “investment account.” *ODR Hrg. Transcr. 50:21- 51:4*.
8. Mr. Whitehead claimed a deduction of \$53,000 for a contribution to an individual 401(k) plan on his 2017 Return. *Dept. Ex. D*.
9. On November 12, 2018, the Internal Revenue Service (IRS) amended Mr. Whitehead’s 2017 federal Return, noting: “[w]e didn’t allow the amount claimed on line 36, Form 1040, because the supporting form was incomplete or not attached to your tax return.” *Dept. Ex. J*. The IRS’s adjustment disallowed Mr. Whitehead’s claimed deduction for contributions to a 401(k) in tax year 2017. *Taxpayer Ex. 1*.
10. On November 16, 2018, Department auditor Karolee Weickum initiated an audit of Mr. Whitehead’s 2017 Return and requested additional information relating to the return by letter. *MTAB Hrg. Transcr. 21:2-14; Taxpayer Ex. 1*. Specifically, Ms. Weickum requested complete copies of pages one and two of Mr. Whitehead’s 2017 Federal Form 1040, his Federal schedule B, all earnings and withholding statements, Federal Form(s) W-2, any

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF REVENUE

Form(s) 1099, Schedule(s) K-1, and any documents reporting income “even if the earnings or withholding may be for another state.” *ODR Ex. B.* Ms. Weickum also asked for copies of Mr. Whitehead’s Form(s) 1099-R and documentation verifying the total amount of social security benefits Mr. Whitehead had received each month and for the year. *Id.*

11. Mr. Whitehead responded to Ms. Weickum’s information request letter on December 1, 2018. *Taxpayer Ex. 1.* Mr. Whitehead’s letter included a copy of his 2017 federal Form 1040 as well as his response to the IRS’s question regarding that form. *ODR Ex. E.* Mr. Whitehead indicated that the IRS had asked him to verify his individual 401(k) account. *Id.* He also indicated that he submitted his Schedule B, that he had no K-1 for 2017, that he had provided a W-2, and that he submitted a Form 1099-R. *Id.*
12. Neither the Department nor Mr. Whitehead submitted copies of the documents Mr. Whitehead included with his letter, other than the 1099-Rs and the final K-1 from GIP. *Dept. Ex. F, K; ODR Ex. B.*
13. After Ms. Weickum reviewed Mr. Whitehead’s information, she determined Mr. Whitehead’s 2017 Return had been filed under an erroneous social security number, and as a result, he had two taxpayer accounts. *Taxpayer Ex. 1.* The accounts were combined, and the audit was later expanded to include Mr. Whitehead’s 2016 Montana tax return (2016 Return). *Id.*
14. The first 2016 1099-R issued by Charles Schwab & Co. (Schwab) indicates a distribution from either a traditional IRA, a 401(k), or an annuity plan in the amount of \$181,965.70. *Dept. Ex. F.* The distribution is shown to have been made from an account number ending in 1695. *Id.*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

15. The 1099-R designates the distribution as a normal distribution using reporting code 7 and indicates the taxable amount of the distribution **had not been determined**. (*Emphasis added*). *Dept. Ex. F*. The document does not contain an alphabetical designation along with the numerical designation and is not identified as a conversion or a direct rollover. The document does not indicate the date on which the distribution was made but does identify it as a 2016 distribution.

16. The second 2016 1099-R issued by Schwab indicates a distribution in the amount of \$59,000 for which the taxable amount had also not been determined. *Dept. Ex. F*. The distribution was identified as a direct (trustee to trustee) rollover. The document does not indicate the date on which the distribution was made but does identify it as a 2016 distribution. This distribution was not at issue in this matter.

17. Following the ODR hearing and without objection from the Department, Mr. Whitehead submitted a copy of a 2016 Federal Form 5498 from Schwab showing rollover contributions in the amount of \$59,000 and a Roth IRA conversion in the amount of \$181,965.70. *Dept. Ex. H*. This document does not indicate the date on which either the transfer or the conversion was made.

18. Ms. Weickum notified Mr. Whitehead by audit adjustment letter dated December 12, 2018, that she had adjusted his 2017 tax return to reflect adjustments made by the IRS on Mr. Whitehead's Federal Return "because Montana follows Federal." *Dept. Ex. J*. The letter did not specifically set out the basis for the federal adjustment. However, the Department's brief indicates it was the result of the IRS' disallowance of Mr. Whitehead's claimed deductions for a contribution to a 401(k) plan. *Taxpayer Ex. 1*. The IRS adjustment increased Mr. Whitehead's federal adjusted gross income. *Dept. Ex. J*. As a result of that adjustment, Mr. Whitehead's Montana AGI increased as did the taxable amount of Mr.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

Whitehead's social security benefit. *Taxpayer Ex. 1; Dept. J.* Ms. Weickum's adjustment letter did not address Mr. Whitehead's 2016 return which the Department stated was included in the expanded review. *Dept. Ex. J.*

19. Mr. Whitehead filed an amended 2016 Montana Individual Income Tax Return (2016 Amended Return) on December 17, 2018, five days after Ms. Weickum issued her audit adjustment letter. *Dept. Ex. C.* The Department's Exhibit C is a copy of a 2016 Montana Individual Income Tax Return filed by Mr. Whitehead and received by the Department on December 17, 2018, with a notation on page three stating "[e]xtension was submitted on original," but there is nothing more on the document to indicate it is an amended return. *Id.* No other version of a 2016 Amended Return has been submitted by either party.
20. On the 2016 Amended Return Mr. Whitehead claimed a deduction for a contribution to a 401(k) in the amount of \$53,000 just as he claimed on his 2017 Return. *Dept. Ex. C.* The 2017 deduction had previously been denied by the DOR and the IRS. Mr. Whitehead also claimed a new deduction in the amount of \$50,044 for interest expenses. *Id.*
21. On December 27, 2018, Mr. Whitehead sent auditor Pam Plaska a letter asking about a change the Department had made to his taxable social security. *Taxpayer Ex. 1.*
22. Ms. Plaska reviewed Mr. Whitehead's 2016 Amended Return on January 3, 2019, and "made the same adjustments that were made to the 2017 return, based on the same reasons." *Taxpayer Ex. 1.* There is no evidence in the record that Ms. Plaska issued an audit adjustment letter or NOA notifying him of her adjustments or of his right to informal review of those adjustments. *MTAB Hrg. Transcr. 22:3-5.*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

23. Mr. Whitehead responded to Ms. Plaska by letter dated February 19, 2019, addressing the issues he had raised previously. *ODR Ex. F*. He indicated that he had attached copies of numerous documents to the letter, however, those documents were not included in the ODR or MTAB record by either party.
24. On March 15, 2019, Mr. Whitehead filed an APLS102F with the ODR Office. *Taxpayer Ex. 1*. However, because there was no evidence that an informal review had been conducted, the document was forwarded to the Business and Income Tax Division using this ODR Office's standard process. *Id.*
25. Mr. Merrien and Mr. Whitehead spoke on the telephone on May 1, 2019, to attempt to clarify Mr. Whitehead's tax situation. *Taxpayer Ex. 1*.
26. On May 8, 2019, Mr. Whitehead sent a letter to Mr. Merrien which included documents labeled "Exhibits A thru F" as follows⁴:
- a. A includes a sales contract signed by Mr. Whitehead on October 1, 2015, in which Mr. Whitehead agreed to buy and the U.S. Department of Housing and Urban Development (HUD) agreed to sell a residential property located in Butte, Montana. Exhibit A also included a one-page document entitled Title Insurance Commitment dated September 5, 2016, with a handwritten note stating, "sold Butte home at 1829 Utah Avenue, Butte, MT 59701".
 - b. B includes Mr. Whitehead's 2016 Federal Capital Gains and Losses Schedule D.

⁴ The Taxpayer Exhibits A-F as included in this paragraph are separate from the DOR Exhibits at ODR and the DOR Exhibits at MTAB and were not introduced into the record as Exhibits A-F. They have been included in the record as ODR Exhibit G and, for purposes of the MTAB hearing, Taxpayer's Exhibit 11, although MTAB Taxpayer's Exhibit 11 does not include each page that was originally submitted at ODR.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

- c. C includes a letter dated February 26, 2017, from GIP to Mr. Whitehead indicating a 2016 Federal K-1 Form 1065 was enclosed and noting that because 2016 was the last year in which GIP would file a federal Partnership Return, the enclosed K-1 would be the last one Mr. Whitehead would receive. This exhibit also included a copy of the final K-1 referenced in the letter,⁵ and an amended 2016 Montana K-1 from GIP to Mr. Whitehead.⁶
- d. D included a copy of a letter dated April 24, 2017, from GIP as the landlord to Terry Richmond at Morrison-Maierle, Inc. as the tenant, offering a proposed multi-year lease agreement for business property to be built in Kalispell, Montana, while also indicating that the GIP representatives, Mr. Whitehead, William Buxton, and Brian Solan were all employees of Morrison-Maierle; Articles of Organization for GIP signed by Mr. Whitehead, but undated and unnotarized; a loan document dated December 29, 2008, noting the creditor as Three Rivers Bank of Montana, the grantor as GIP, and the borrowers as 11 individuals including Mr. Whitehead who were all employees of Morrison-Maierle and/or ADG Development Company; a memorandum of understanding dated May 9, 2007, between ADG Development and GIP regarding the construction of the Kalispell office property which addressed, among other things, the \$50,000 individual investment requirement for GIP, two pages of an 11-page deed of trust between Countrywide Home Loans, Inc. and Mr. Whitehead;⁷ and an email from Pierre Kaptanian to Mr. Whitehead dated September

⁵ The copy of the K-1 submitted by the Department contains handwritten notations. It is not clear from the document whether the written notations were made by Mr. Whitehead or by someone in the Department.

⁶ The record does not contain a copy of the original 2016 Montana K-1 issued to Mr. Whitehead.

⁷ A complete copy of the deed was not provided nor was a copy of the underlying note which established the deed. Therefore, there is no evidence regarding the purpose of the loan, other than a handwritten note stating “[p]ersonal loan for construction of investment property/office building.”

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

10, 2009, with the subject line of “M-M Office Pay Request #1” regarding a transfer of \$75,160 to GIP’s checking account from “the Construction Line of Credit.”

- e. E includes a copy of page 435 of the U.S. Master Tax Guide addressing limitations on investment interest deduction with handwritten notations.
- f. F is a blank copy of IRS Schedule SE (Form 1040); and a copy of a tax year 2018 Instructions for Schedule SE (Form 1040) with handwritten notes, highlighting, and underlining throughout.

ODR Ex. G; Taxpayer Ex. 11.

27. On June 12, 2019, Mr. Whitehead sent Mr. Merrien another letter trying to explain why he believed he did not owe a tax liability and countering statements it appears were made by Mr. Merrien in response to Mr. Whitehead’s May 8, 2019 letter.⁸ *Taxpayer Ex. 12.*

28. Mr. Whitehead's June 12, 2019 letter indicated it included exhibits A through I, however, the copy of the exhibits provided by the Department did not include a document identified as “Exhibit E.” *Taxpayer Ex. 12.*

29. The June 12 letter included an IRS document entitled Rollover Chart with handwritten notes; a copy of page 435 of the U. S. Master Tax Guide, year unknown, with underlining, highlighting, and other markings. *Taxpayer Ex. 12.* Also included was a two-page spreadsheet identified as “Morrison Maierle Office Building,” marked and highlighted by hand and dated May 8, 2007, and a copy of the first three pages of an article from the Journal of Accountancy entitled IRS pursuing self-employment taxes from LLC members dated May 1, 2018. *Taxpayer Ex. 12.* As noted above, a copy of Exhibit E to that letter was not produced.

⁸ There is no evidence in the record regarding Mr. Merrien's response to Mr. Whitehead's May 8, 2019 letter.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

30. The June 12 letter also included a copy of IRS Form 8949 for tax year 2016 completed in handwriting and describing the property disposed of as “House at 1829 Utah Ave., Butte Montana” showing an overall loss of \$13,588. *Taxpayer Ex. 12*. It is unclear whether this document was filed with the IRS. The letter also contained a copy of a 2017 IRS Form 4952 with the tax year stricken and “2016” inserted in handwriting. *Id.* The document is completed in handwriting and identifies an investment interest expense paid or accrued in 2016 in the amount of \$50,000, gross income from property held for investment in the amount of \$100,008, investment income in the amount of \$160,000, with a net investment income of \$110,008 and an investment interest expense deduction of \$50,000. *Id.* The letter also included a copy of page two of an IRS Form 1040X with a handwritten explanation of changes signed by Mr. Whitehead and dated September 17, 2018. *Id.* The remaining pages of the 1040X were not included.
31. Finally, the letter included a copy of the February 26, 2017, letter from GIP to Mr. Whitehead and federal and Montana Schedules K-1 previously attached to Mr. Whitehead's May 8, 2019, letter to Mr. Merrien. *Taxpayer Ex. 12*. It also included a copy of a check written by Mr. Whitehead to Schwab on a check from a First National Bank of Montana account held by ETA Enterprises and Purnal Whitehead. *Id.* The notation on the check states “After Tax Deposit to Acct., Individual 401-K [XXXX]-1610.” *Id.* There is no evidence in the record to indicate when the notation was made.
32. Following review of the documentation submitted by Mr. Whitehead on May 8 and June 12, Mr. Merrien responded by letter dated July 16, 2019, noting that the letter was in response to Mr. Whitehead's February 19, 2019, letter and apologizing because the response had been delayed by Mr. Whitehead's submission of the March 15, 2019, APLS102F. *Dept. Ex. E.*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

33. In his letter, Mr. Merrien indicated that he had further adjusted Mr. Whitehead's 2016 Amended Return. *Dept. Ex. E.* Mr. Merrien's adjustments related to the 401(k) contribution deduction which had been previously denied for the 2017 tax year, and two new adjustments, one relating to Mr. Whitehead's deduction of interest expenses and the other relating to the \$181,966 Schwab distribution. *Id.*

34. Mr. Merrien also indicated that while Mr. Whitehead had taken a deduction in the amount of \$53,000 for a contribution to a "self-employment account," neither Mr. Whitehead's amended 2016 nor his 2017 returns show any income earned from self-employment. *Dept. Ex. E.* Mr. Merrien acknowledged that Mr. Whitehead had provided a copy of the K-1 he received from GIP but noted that the K-1 did not show any earned income from which the claimed deduction could be taken. *Id.* Mr. Merrien also noted that IRC S 404(a)(8)(C) limits deductions for self-employment expenses to the amount of income earned from that self-employment. *Id.* He further noted that IRC §§ 401, 1401, and 1402 also governed his denial of Mr. Whitehead's claimed deduction. *Id.*

35. Mr. Merrien further advised Mr. Whitehead that his 2016 Amended Return had been adjusted to include the \$181,966 1099-R distribution from Schwab in Mr. Whitehead's income. *Dept. Ex. E.* Mr. Merrien noted that Mr. Whitehead had originally claimed that the funds were borrowed from Mr. Whitehead's Schwab investment account to purchase the Butte, Montana property in 2015, but that he had subsequently argued the distribution was actually "a Roth conversion with prepaid taxes." *Id.* Mr. Merrien indicated that Mr. Whitehead had failed to provide sufficient substantiation to support his claim. *Id.* He explained that while conversion of a Traditional IRA to a Roth IRA is considered a rollover for the purposes of the Roth IRA, it does not change the fact that distributions from a Traditional IRA are taxable in the year the funds are received regardless of whether there is a conversion. *Id.* Mr. Merrien further noted that Mr. Whitehead had failed to provide a

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

federal Form 8606 and that he had failed to provide any evidence to show that he had a basis to reduce his taxable income because he did not provide account statements or copies of Forms 8606 for prior years. *Id.*

36. Finally, Mr. Merrien indicated that he had denied Mr. Whitehead's 2016 claimed deduction of \$50,044 in investment interest. *Dept. Ex. E.* He noted that Mr. Whitehead had acknowledged he had borrowed \$289,000 to invest in GIP and that the contribution was distributed back to Mr. Whitehead when GIP was dissolved. *Id.* Mr. Merrien's letter advised Mr. Whitehead of his right to informal review and indicated that he had 30 days from the date of the letter in which to request review. *Id.*
37. On August 6, 2019, Mr. Whitehead responded to Mr. Merrien's adjustment letter and requested an informal review. *Taxpayer Ex. 7.* Mr. Whitehead's letter again explained his position regarding the adjustments. *Id.* It included documents identified as Exhibits 1-7. *Id.*
38. Mr. Whitehead's letter included a complete version of the Journal of Accountancy article identified in Finding 29; a copy of the letter from GIP and the federal and Montana K-1s previously identified, with the copy of the federal K-1 including handwritten notes throughout. *Taxpayer Ex. 7.* The letter also included a copy of the IRS Rollover Chart previously identified; and a copy of a 2016 IRS Form 8606 relating to Nondeductible IRAs signed by Mr. Whitehead and dated August 5, 2019, eight months after he filed his 2016 Amended Return. *Id.* Line one of the document identified a nondeductible contribution to traditional IRAs in the amount of \$181,966. *Id.* Line 2, which required entry of Mr. Whitehead's total basis in traditional IRAs was notated "no limit," but no dollar amount was entered into line 2. *Id.* On page 2 of the document, Mr. Whitehead calculated the taxable amount of his claimed contribution to be \$0. *Id.*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

39. Also included was page 8 of a nine-page document entitled ‘Charles Schwab Bank Deposit Account Activity’ for the statement period November 1, 2016, to December 31, 2016. *Taxpayer Ex. 7.* The statement showed there had been an IRA conversion in the amount of \$181,965.70. *Id.* The last document included was a copy of the spreadsheet identified as “Morrison Maierle Office Building,” marked and highlighted by hand and dated May 8, 2007. *Id.*
40. Field Audit Manager Brian Olsen conducted an informal review on September 13, 2019. *Taxpayer Ex. 6, 8.* Mr. Olsen’s determination upheld the Department’s audit adjustments. *Id.* Mr. Olsen noted that deduction for contributions to SEP, SIMPLE, and Qualified Plans claimed by Mr. Whitehead on his 2017 Return and then again on his amended 2016 Amended Return after the deduction had been denied for 2017, were generally deductible when an individual has income either from self-employment or from being a partner of a business who materially participates in the activities of the business. *Id.* Mr. Olsen further noted that he did not dispute that Mr. Whitehead was a partner in GIP, but that the income he obtained from the partnership was passive income and not generated by active participation in the partnership. *Id.* Therefore, he concluded, the deduction was not allowable. *Id.*
41. Regarding Mr. Whitehead’s 2016 1099-R distribution of \$181,966, Mr. Olsen denied the claim because, while he saw discussions of explanations of rollovers that may have been excludable, there was not sufficient evidence to prove that qualifying distributions occurred. *Taxpayer Ex. 6, 8.*
42. Finally, regarding Mr. Whitehead’s 2016 interest expense deduction, Mr. Olsen explained that such deductions were only allowable against related income. *Taxpayer Ex. 6, 8.* Mr. Olsen noted that the interest expense was the result of a loan taken to invest in GIP and

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

could, therefore, only be deducted to the extent that GIP passed rental income to Mr. Whitehead. *Id.*

43. Mr. Whitehead filed his appeal with the Office of Dispute Resolution (ODR) on October 8, 2019, and a hearing was held on February 4 and 5, 2020. ODR issued its final decision on May 7, 2021, and found that the DOR had adjusted Mr. Whitehead's 2016 and 2017 Montana Individual Tax Returns correctly and the tax, penalties, and interest accruing from such adjustment are properly due and owing. *ODR Opinion 2019-717-IT-M.*
44. Mr. Whitehead appealed to MTAB on June 02, 2021, and a hearing was held on October 26, 2021.
45. Regarding the Department's adjustment to include the Schwab distribution as part of Mr. Whitehead's total income, Mr. Whitehead argues that he used \$130,500, some of which was taken from his "Schwab stock investment account" and the remainder from his personal checking account to purchase a house in Butte, Montana. *Taxpayer Ex. 7.*
46. Mr. Whitehead used a cashier's check dated October 28, 2015, in the amount of \$130,500.30 to purchase the Butte home. *Taxpayer Ex. 6, 9.* He claims he lived in the house for approximately 11 months while he prepared it for resale. *Taxpayer Ex. 6, 7.*
47. Mr. Whitehead further claims that in addition to the purchase price of the house, he also invested \$53,738 from his Schwab investment accounts and personal checking account to rehabilitate the house for resale which resulted in a total investment of \$184,238, and that the sale of the house for \$170,650 resulted in a loss of \$13,588. *Taxpayer Ex. 6, 9.*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

48. The home sold on September 5, 2016; however, Mr. Whitehead did not deposit any of the proceeds from the sale into an account he referred to as a Schwab “IRA Rollover account” until December 23, 2016, when he deposited \$181,966. *Taxpayer Ex. 7, 9.*
49. Mr. Whitehead has indicated that he was “not worried about the taxes on these funds plus the fix-up funds because [he] knew these were after-tax funds from prior years.” *Taxpayer Ex. 6.* It is unclear whether Mr. Whitehead’s references to “these funds” refers to the original funds taken from his “Schwab Investment account” and his “checking account,” to purchase the Butte house, or to the proceeds from the sale of the Butte house. *Id.*
50. It is also unclear from the record whether the Schwab “IRA Rollover account” is the same account as the “Schwab Investment account” from which Mr. Whitehead withdrew the money used to purchase the Butte house.
51. During the ODR hearing, Mr. Whitehead testified that he deposited \$159,000 of the proceeds from the sale of the house into his Schwab account number 1711 which he stated is a “pre-account before it goes into a Roth account.” *ODR Hrg. Transcr. 49:11-14, 13:17-20.* Mr. Whitehead referred to the Schwab account ending in 1711 as a checking account. *ODR Hrg. Transcr. 49:16-18.*
52. During the MTAB hearing, Mr. Whitehead testified that he also deposited \$204,000 of the distribution he received from GIP in 2016 into his checking account and then into the Schwab account. *MTAB Hrg. Transcr. 13:7-17.*
53. He asserts that because both the proceeds from the sale of the house and the distribution from GIP were taxed prior to having been deposited into the Schwab checking account, and subsequently converted into his Roth account from his individual 401(k) account, the

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

Department should not tax the converted funds. *MTAB Hrg. Transcr. 10:13-23, 14:7-11; Taxpayer Ex. 9.*

54. In response to the Department's initial adjustment denying his claimed \$53,000 401(k) contribution deduction, Mr. Whitehead argues that there is no provision in the IRC that prevents him from taking the claimed self-employment retirement contribution deduction because the income generated by GIP was considered passive income. *Taxpayer Ex. 8.* He also argues that the \$53,000 retirement contribution “came from the sale of GIP (MMI Office Building) Partnership.” *Taxpayer Ex. 7, 8.*

55. Mr. Whitehead further asserts that the 2016 sale of the GIP-MMI Office Building was the sale of a capital asset which does not require self-employment taxes. *Taxpayer Ex. 2, 7, 8; MTAB Hrg. Transcr. 40:9-11.*

56. Mr. Whitehead claims he contributed a total of \$59,000 into his retirement fund, \$6,000 of which he could have used as a catch-up, but that he did not deduct the catch-up portion. *Taxpayer Ex. 2, 7, 8; MTAB Hrg. Transcr. 39:13-23.* He initially claimed the \$53,000 retirement contribution on his 2017 Return and then again on his 2016 Amended Return after the 2017 claim had been denied by the Department. *Dept. Ex. C, D.*

57. Regarding the Department’s denial of Mr. Whitehead’s claimed interest expense deduction of \$50,044, Mr. Whitehead claims that the deduction was related to his 2007 \$50,000 startup investment in GIP. *Taxpayer Ex. 7, 9.*

58. Mr. Whitehead claims he was never paid interest for his 10-year \$50,000 investment. *Taxpayer Ex. 6, 7, 8; MTAB Hrg. Transcr. 64:22-65:11.* Further, Mr. Whitehead claims that

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

after the sale of GIP, the loan became a bad debt, and therefore was deductible in the tax year it became worthless. *Taxpayer Ex. 9.*

59. Between 2007 and 2015 GIP issued Mr. Whitehead K-1s showing rental income paid to GIP. *ODR Hrg Transcr. 74:5-14.* During the ODR hearing, Mr. Whitehead testified that the rental income was not distributed to Mr. Whitehead or any of the GIP partners, but instead was “plowed back into GIP”. *ODR Hrg Transcr. 74:16- 76:8.*

60. Mr. Whitehead paid interest on the 2007 home equity loan each year but testified during the ODR hearing that he did not claim those interest payments on his tax returns at any time over the 10 years in which he was invested in GIP. *ODR Hrg Transcr. 76:9-12.* He testified that he instead claimed all the interest he paid over that period in 2016 when he received the final distribution of funds from GIP. *ODR Hrg Transcr. 3:22-4:11.*

61. GIP wound up operations in 2016 and a full reconveyance was filed October 26, 2016. *Taxpayer Ex. 8.* Mr. Whitehead received distributions from GIP in the amount of \$209,952 as indicated on the final 2016 K-1. *Id.*

62. Mr. Whitehead was a passive investor in GIP. *Taxpayer Ex. 2, 7; MTAB Hrg. Transcr. 41:17-19, 43:8-25.* He did not actively participate in GIP, did not perform services for GIP and was not paid self-employment income from GIP.

63. GIP’s income came from the rental of the MMI Office building and possibly some interest. *MTAB Hrg. Transcr. 55:8-14; 50:22-23.*

64. The evidence in the record clearly indicates that Mr. Whitehead never received or reported any self-employment income from ETA in either 2016 or 2017.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

JURISDICTION AND STANDARD OF REVIEW

65. The Montana Tax Appeal Board is an independent agency not affiliated with the Montana Department of Revenue. *Mont. Const., Art. VIII § 7; Mont. Code Ann. § 15-2-101*. The Taxpayer filed a timely appeal of the DOR's decision to the MTAB. Therefore, this Board maintains jurisdiction to hear and decide this matter, a direct appeal to MTAB from a decision of the DOR. *Mont. Code Ann. § 15-2-302*.
66. This Board may hear appeals de novo. *Puget Sound Energy, Inc. v. State*, 2011 MT 141, ¶ 30, 361 Mont. 39, 255 P.3d 171. "A trial de novo means trying the matter anew, the same as if it had not been heard before and as if no decision had been previously rendered." *McDunn v. Arnold*, 2013 MT 138, 303 P.3d 1279 (2013).
67. The Board's order is final and binding upon all parties unless changed by judicial review. *Mont. Code Ann. § 15-2-302*.

CONCLUSIONS OF LAW

68. To whatever extent the following conclusions of law may be construed as findings of fact, they are incorporated accordingly.
69. 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.
70. "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)*.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

71. “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)*.
72. “[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*.
73. “[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)*.
74. “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.
75. “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*, ¶ 12 (Quoting *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992)).
76. 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).
77. 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

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

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

78. The IRS acknowledges numerous types of retirement plans as qualified for purposes of taxation. *26 U.S.C. §§ 401, 415.*

79. IRA-based plans include simplified employee pension plans (SEP), and savings incentive match plans for employees of small employer plans (SIMPLE). *Id.*

80. Defined contribution plans include profit sharing, safe harbor 401(k)s, automatic enrollment 401(k)s, and traditional 401(k)s. *26 U.S.C. § 401, Pub 3998.*

81. Employer eligibility, employer's role, contributors, maximum annual contributions, contributor options, minimum employee coverage requirement, withdrawals, loans and payments, and vesting rules differ from plan type to plan type. *26 U.S.C. § 401, IRS Pub. 3988.*

82. Self-employed individuals may utilize SEP, SIMPLE IRA, and 401(k) plans (including solo 401(k) plans), as well as defined benefit plans, profit-sharing plans, and money purchase plans. *Retirement Plans for Self-Employed People*, <https://www.irs.gov/retirement-plans/retirement-plans-for-self-employed-people>, Last viewed January 14, 2022; *see 26 U.S.C. §§ 401, 408, 415.*

83. An individual is considered self-employed if the individual has earned income from self-employment in a given tax year. *26 U.S.C. § 401(c)(1).*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

84. Earned income means the net earnings from an individual's self-employment, but only to the extent that the income is generated by a trade or business in which the individual's services are a material factor in the production of the income. *Id.* at (2). Net earnings also include any distributive shares of income or loss whether or not distributed if the trade or business is carried on by a partnership of which the individual is a member. *20 U.S.C. § 401(2), 26 U.S.C. § 1402* (emphasis added).
85. Self-employment income means net-earnings (earned income) less certain excluded income not relevant to this matter. *26 U.S.C. § 1402(b)*.
86. A self-employed individual's compensation for purposes of retirement plans is the individual's earned income, provided the individual's personal services are a *material income-producing factor*. *Id.* (emphasis added). Allowable deductions include the deductible portion of the individual's self-employment tax. *Id.* Net earnings include a partner's distributive share of partnership income or loss [whether or not distributed] (other than separately stated items, such as capital gains and losses). *26 U.S.C. § 1402(a)*.
87. The determination of whether a taxpayer is "carrying on a business" requires examination of the facts in each case. *Higgins v. Com'r*, 312 U.S. 212, 217, 61 S. Ct. 475, 478, 85 L. Ed. 783. The "mere managerial attention to investments for the conservation and enhancement" of such investments is not carrying on a business or trade. *Id.*
88. Compensation does not include "earnings and profits from property such as rental income, interest income, and dividend income" or "income from a partnership for which an individual did not provide services that are a material income-producing factor." *IRS Publication 590-A; See 26 U.S.C. § 1402(a)(1)*. Personal services must be actually rendered to the partnership. *26 U.S.C. § 415(c), 26 CFR § 1.415(c)-(d), IRS Pub. 560 (2016)*.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

89. An individual who is self-employed may be considered an owner-employee if the individual owns the entire interest in an unincorporated trade or business. Individuals who are partners in a partnership and who own more than 10 percent of either the capital interest or profits interest in the partnership, are also considered owner-employees. *26 U.S.C. § 401(c)(3)(B)*.
90. The deductions for contributions to a SEP plan by self-employed individuals are limited and based upon the individual's compensation. *26 U.S.C. § 415(b), IRS Pub. 560 (2016)*.
91. In 2016, a self-employed individual with a SEP retirement plan was allowed to contribute pre-tax up to the lesser of 25% of their compensation or \$53,000. *26 U.S.C. § 415(b), IRS Pub. 560 (2016)*. In 2017, contributions were limited to the lesser of 25% of the self-employed individual's compensation or \$54,000. *Id.*
92. SIMPLE IRA plan pre-tax contributions were limited to \$12,500 in both 2016 and 2017. *26 U.S.C. § 408(p), IRS Pub. 560 (2016)*. Pre-tax catch-up contributions for qualifying participants were limited to \$3,000. *Id.* As with SEP plans, SIMPLE IRA contributions and deductions were based on the self-employed individual's compensation. *26 U.S.C. § 408(p)*. Absent self-employment income, no contributions to a SEP or SIMPLE IRA are deductible. *Id.*
93. Other qualified plans, including defined contribution and defined benefit plans also had contribution limits in 2016 and 2017. *26 U.S.C. §§ 415(b), (c), 401*. In 2016, defined benefit plan pre-tax contributions were limited to the lesser of 100% of a contributor's average compensation or \$210,000 (\$215,000 in 2017). *26 U.S.C. § 415(b)*. Pre-tax contributions to defined contribution plans in 2016 were limited to the lesser of 100% of a contributor's average compensation or \$53,000 (\$54,000 in 2017). *26 U.S.C. § 415(c)*.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

94. 401(k) plans are also qualified plans for tax purposes. The two types of 401(k) discussed in this decision are traditional 401(k)s and Roth 401(k)s.
95. Qualified contributions to a traditional 401(k) are generally deductible in the year in which they are contributed. *26 U.S.C. § 402(g), IRS Pub. 509-A*. Because these contributions are deductible, they are referred to as pre-tax or tax deferred contributions. Because the contributions are not taxed, the distributions from the plan must be. *Id.*
96. Distributions from a 401(k) are fully taxable if all contributions were deducted. *26 U.S.C. § 402(b), IRS Pub. 509-B*.
97. Pre-tax contributions are limited by law. The basic limit on pre-tax contributions in both 2016 and 2017 was \$18,000 plus any qualified catch-up payments. *26 U.S.C. § 402(g)(1)*.
98. An individual may make non-deductible (post-tax) contributions to his or her 401(k), however, the total contributions from all sources, including pre-tax and post-tax contributions combined, was limited to \$53,000 in 2016 and \$54,000 in 2017. *26 U.S.C. § 415(c)*.
99. If post-tax contributions were made to the individual's 401(k), the individual has a basis in those funds and, therefore, distributions of those post-tax contributions are not further taxed. *IRS Pub. 509-B*.
100. Roth IRAs are similar to traditional IRAs; however, Roth contributions are made post-tax. *26 U.S.C. § 408A(c)*. Roth contributions are included in the individual's gross income and are not deductible. *Id.* Because Roth contributions are taxed at the time they are made, distributions from the Roth account are not taxed. *26 U.S.C. § 402(b)*.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

101. Self-employed individuals may only make contributions to qualified plans, including solo-401(k)s, if they have net earnings (compensation) resulting from their personal services to their trade or business. *26 U.S.C. § 401(c), (d), 26 U.S.C. § 415(c)(3), IRS Pub. 560.*

102. Contributions made to one IRA can be rolled over from one IRA to another in one of three ways. They may be rolled over directly from one IRA to another by the plan administrator with no distribution being made to the individual. *26 C.F.R. § 1.401(a)(31)-1.* Roll overs may also be completed by the individual account owner. In these cases, the plan administrator distributes funds from an IRA to the individual account owner and the individual deposits or "rolls" the distribution into another qualifying IRA. *Id.* Trustee-to-trustee rollovers are also allowable, however, since the rollovers at issue in this matter were not made between trustees, this type of roll over will not be discussed further.

103. An individual may also roll contributions from a traditional IRA over to a Roth IRA. *26 C.F.R. § 1.408A-4.* Rollovers from a traditional IRA to a Roth IRA are called conversions. Conversions are governed by the same laws as rollovers between traditional IRAs. *Id.*

104. If a conversion is made to a Roth IRA from a traditional IRA, any previously untaxed amounts must be included in the individual's gross income and taxed at the time of the conversion. *26 U.S.C. § 408(1).*

105. Rollovers must be completed no more than 60 days after the rollover funds have been received by the individual. *26 U.S.C. §§ 408(d)(3), 402(c)(3).* If pre-tax contributions are disbursed from a traditional IRA and are not rolled over to another IRA within the 60-day period, the distribution is fully taxable. *26 U.S.C. § 402(b), (c).*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

106. Interest on indebtedness is deductible in the year in which it is paid or accrued. *26 U.S.C. § 163(a)*.
107. Non-corporate taxpayers may deduct investment interest only to the extent the taxpayer has investment income. *Id. at (d)(1)*. Investment interest is interest paid or accrued on indebtedness allocable to property held for investment. *Id. at (d)(3)*.
108. Investment interest does not include any qualified residence interest. *Id.*
109. Qualified residence interest is interest paid during the taxable year on acquisition or home equity indebtedness on any qualified residence. *26 U.S.C. § 163(h)(3)*.
110. Acquisition debt is debt incurred to acquire, construct, or substantially improve a qualifying residence, and which is secured by that residence. *Id. at (B)*. The maximum aggregate amount of debt which may be treated as acquisition debt is \$1,000,000 unless the taxpayer is a married individual filing a separate return, in which case, the amount is \$500,000. *Id.*
111. Home equity debt is any debt other than acquisition debt, which is secured by a qualified residence to the extent the debt does not exceed the fair market value of residence less and acquisition debt encumbering the residence. *Id. at (C)*. The aggregate amount of home equity debt is limited to \$100,000, or if the taxpayer is married but filing a separate return, \$50,000. *Id.*
112. Indebtedness incurred prior to October 13, 1987 (Grandfathered Debt) that was and remains secured by a qualified residence in the tax year interest is paid or accrued, is treated as acquisition debt. *Id. at (D)*. The aggregate acquisition debt limit identified in Conclusion 110, above, is reduced (but not below zero) by any outstanding Grandfathered Debt. *Id.*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

113. A qualified residence is the principal residence of the taxpayer and may include one additional residence used by the taxpayer as a residence. *26 U.S.C. § 163(h)(4)*.
114. Interest paid or accrued on acquisition, home equity, and/or grandfathered debt is deductible within the limits set out above. *26 U.S.C. § 163(h)*.
115. A taxpayer must prove his or her right to the claimed deduction by a preponderance of evidence. *Mont. Env'tl. Info. Ctn v. Mont Dep't of Env'tl. Quality*, 2005 MT 96, ¶ 22, 326 Mont. 509, 112 P.3d 964.
116. A preponderance of evidence is a modest standard that requires a taxpayer to prove it is more probable than not all statutory criteria have been met. *Hohenlohe v. State*, 2010 MT 203, ¶ 33, 357 Mont. 438, 240 P.3d 628.
117. Taxpayers must keep and produce adequate records to substantiate any deductions that they claim. *Hradesky v. Comm'r*, 65 T.C. 87, 89-90 (1975), *aff'd per curiam* 540 F.2d 821 (5th Cir. 1976), *Meneguzzo va Comm'r*, 43 T.C. 731, 742-743 (1985); *see also* *26 U.S.C. § 1.6001-1(a)*.
118. The initial burden of proof is on Whitehead in this case. *Mont. Code Ann. § 26-1-401*.
119. If Whitehead provides sufficient evidence to prove his case, the burden will shift to the Department. *Id.*
120. Whitehead, or the Department if the burden has shifted, must persuade the Board as to each fact that is essential to the party's claim for relief or defense the party is asserting. *Mont. Code Ann. § 26-1-402*.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

DISCUSSION

Issue one: Whether Mr. Whitehead's 1099-R conversion is taxable

121. DOR stated in the January 21, 2020, letter that if the Taxpayer could not show that he contributed the funds to his Schwab account in 2016, the full amount must be included in gross income. Taxpayer testified his letter of March 31, 2021 shows complete monthly conversion for 2016 to Roth IRA. *MTAB Hrg. Transcr. 10:1-6*. The Taxpayer provided documentation that shows the conversion from the Traditional IRA to the Roth IRA, but it does not show evidence of the contribution(s) to the Traditional IRA. There is no doubt the amount was a conversion based on the Form 1099-R and Form 5498 issued to the Taxpayer, but a conversion from a Traditional IRA to a Roth IRA is a taxable event unless the Taxpayer can demonstrate he has basis in the amount converted. This could be shown by providing a filed IRS Form 8606 from prior years showing that non-deductible contributions were made. If the contribution to the Traditional IRA was made in the same year as the conversion to the Roth IRA (2016), then the annual account statement from the Schwab Traditional IRA account showing that the funds were initially contributed to that account prior to being converted to the Roth IRA may have provided the necessary information. The Taxpayer did not provide any documentation to show that he either: (1) had basis in the Traditional IRA funds from previous years' nondeductible contributions, or (2) that he initially contributed the funds to his Traditional IRA in 2016 before converting the funds to the Roth IRA in 2016. A conversion from a Traditional IRA to a Roth IRA is taxable in the year of the conversion the same as if the funds had been distributed.
122. Taxpayer received a federal Form 1099-R showing the distribution of the funds from the Traditional IRA account, but he did not include that amount in his gross income for 2016. He initially explained that he borrowed the funds from an investment account to purchase a house in Butte on 10/1/2015, which he later sold. Taxpayer stated that the entire amount

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

reported on the Form 1099-R was a Roth conversion “with prepaid taxes.” The DOR stated in the January 21, 2020, letter that the explanation was not substantiated and did not explain the non-recognition of income. *MTAB Hrg. Transcr. 10:7-16*. In his letter of June 12, 2019, the Taxpayer provided a written explanation of the amounts that add up to the amount converted to the Roth IRA, including proceeds from the sale of the Butte house and from the sale of his interest in GIP, but did not provide supporting documentation to show the funds were deposited into the Traditional IRA in 2016. *Taxpayer Ex. 2, 12*. Without this evidence, the Board is unable to determine if the contributions were made in 2016 or a prior year. The source of the income alone does not demonstrate that the conversion was not taxable. In order to demonstrate that the conversion was not taxable, the Taxpayer must provide some evidence that the initial contributions to the Traditional IRA were never deducted. Because a conversion from a Traditional IRA to a Roth IRA is generally a taxable transaction in the year of conversion, the Taxpayer must provide supporting evidence, beyond the Taxpayer’s own written explanation and testimony, to show that the contributions to the Traditional IRA were not previously deducted.

123. The Taxpayer argued that the DOR erroneously included the IRA distribution in his gross income because the 2016 federal Form 1099-R was updated to Form 5498 later. *MTAB Hrg. Transcr. 10:16-20*. DOR informed Taxpayer that the conversion of a Traditional IRA to a Roth IRA is taxable the same as if it was a distribution. *MTAB Hrg. Transcr. 11:7-10*. The Form 1099-R and Form 5498 are issued separately. Form 1099-R shows distributions from the Traditional IRA, while Form 5498 shows contributions (in this case the conversion) to the Roth IRA. A conversion of a Traditional IRA to a Roth IRA is generally a taxable event. In order to demonstrate otherwise, the Taxpayer is required to provide documentation showing that the initial contributions to the Traditional IRA were never deducted. The Form 1099-R and the Form 5498 each provide different information about the conversion, but neither form provides the information needed to prove this was not a taxable event.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

124. In its letter dated January 21, 2020, the Department informed the Taxpayer that it was ready to reconsider its position if the Taxpayer provided the entire account statement for the Roth IRA account. *MTAB Hrg. Transcr. 18-20*. However, Taxpayer did not send the entire account statement to the DOR on March 31, 2021, more than a year after the DOR's letter and more than a month after the ODR hearing had concluded. *Taxpayer Ex. 1*. The Roth IRA statement account did not provide the necessary information. The DOR had requested information from the Taxpayer to show the contributions were made to the Traditional IRA in 2016 prior to the conversion to a Roth IRA in the same year. *MTAB Hrg. Transcr. 30:18-31:15*. If the funds were initially contributed to the Traditional IRA in 2016, the information the DOR was seeking may have been included in the year-end statement for the Traditional IRA, but the Taxpayer never provided this information. Furthermore, although the Roth IRA statement did not contain the information the DOR was seeking, this document was not provided to the DOR for more than a year after the DOR issued the January 21, 2020 letter. Taxpayers are required to maintain records of their IRA contributions, especially when making contributions in excess of the amount deductible. *MTAB Hrg. Transcr. 35:13-17*. The IRA trustee, in this case Charles Schwab, should have record of contributions and distributions for the account. *Id.*
125. Taxpayer provided ample testimony that he believed tax had been paid on the \$181,965.70 converted from the Traditional IRA to his Roth IRA. However, the Taxpayer failed to submit credible evidence to prove to this Board that he had not previously deducted the contributions prior to the conversion. Mr. Whitehead holds the firm belief that he has done nothing wrong and that the DOR merely does not understand his methodology. In this forum we are restricted by a burden which assumes the DOR is correct, and it is up to the Taxpayer to convince MTAB that DOR has erred. Our decisions must be based on evidence presented and supported by a weighing of the credibility of the testimony from each party to determine whether the Taxpayer has overcome the burden. The Taxpayer did not submit

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

documents to prove he contributed the funds to his Traditional IRA without having deducted those contributions on his tax returns, thus having paid tax on the funds already. He submitted forms and other incomplete documents with unidentified hand-written entries that did not substantiate his claims. For these reasons, this Board upholds the DOR's audit adjustment assessing tax on the 2016 conversion of the Traditional IRA to a Roth IRA.

Issue two: Denial of Mr. Whitehead's Simple, Qualified Plan (SEP) deductions

126. Taxpayer initially claimed a deduction for \$53,000 for contributions to a self-employed retirement account on his 2017 tax return, which the DOR denied because the Taxpayer did not have any self-employment earnings in 2017. *MTAB Hrg. Transcr. 52:12-24.*
127. When the Taxpayer amended his 2016 Tax Return, he claimed the same deduction for \$53,000 for tax year 2016 for contributions to a self-employed retirement account. *MTAB Hrg. Transcr. 39:15-23.* The Taxpayer argued the income he received was from GIP and qualified as earned income, so he was permitted to contribute to a self-employed retirement account the lesser of 100% of the participant plan or \$53,000 for 2016 and \$54,000 for 2017 per 26. U.S.C. 415(c) and 1402(c), along with an additional \$6,000 catch-up amount if over age 59. *Id.* Taxpayer argues that he only deducted \$53,000 for the contribution to his 401(k) account, that he was self-employed through GIP, and that no self-employment tax was required because the sale of GIP was the sale of a capital asset. However, he also testified that he was a passive investor in GIP. *MTAB Hrg. Transcr. 40:17-19.* The DOR noted that Taxpayer was not consistent with the treatment of the income he received from GIP. He treated the income as earned income from self-employment for purposes of contributing to his 401(k) (issue B) and then as investment income for purposes of deducting investment interest expense (issue C). *MTAB Hrg. Transcr. 42:18-22.* Income can either be compensation earned from self-employment or it can be passive investment income, but the same income cannot be both.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

128. “Net earnings from self-employment” means gross income from a trade or business provided the taxpayer’s personal services are material income producing factors minus allowable business deductions. *26 U.S.C. § 1402*. Capital Gains and rental income are specifically excluded from the definition. *Id.*
129. In order for income to be considered self-employed earned income from a partnership, the partner would typically have to be either a general partner or would have to materially participate in the partnership’s activities. *MTAB Hrg. Transcr. 47:1-49:5*; *26 U.S.C. § 401*; *26 U.S.C. 1402*. This is determined at the partnership level, and the K-1 would reflect the self-employed income in box 14. *Id.* The Taxpayer’s K-1 from GIP did not reflect any self-employed income, ordinary business income, or guaranteed payments. *MTAB 41:20-22*; *47:1-49:5*; *26 U.S.C. § 401*; *Dept. Ex. K*. It shows capital gains and net rental income which are both excluded from net income. *MTAB 41:20-22*; *47:1-49:5*; *26 U.S.C. § 401*; *Dept. Ex. K*; *26 U.S.C. §§ 401 and 1402*. Additionally, no earned income from self-employment is reported on the Taxpayer’s 2016 or 2017 Tax Returns. Because deductions for contributions to self-employed 401(k) accounts are limited by the related income earned, this means the allowed deduction for these contributions would be \$0. *MTAB Hrg. Transcr. 41:6-10*. The proceeds from the sale of the GIP membership interest do not qualify as self-employed earned income.
130. Taxpayer argued that he was entitled to make contributions to his ETA 401(k) because he was considered self-employed by GIP. Taxpayer’s contributions to his 401(k) which was set up under ETA must consist of self-employed earned income from ETA, and not from another source. The Taxpayer testified that he did not have any earned income from ETA. *MTAB Hrg. Transcr. 43:5-44:3*.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

131. Even if GIP had set up its own 401(k), the income the Taxpayer received from GIP was not self-employed earned income for purposes of contributing to a 401(k), so he still would not have been able to deduct contributions to a GIP 401(k) had there been one.
132. The Taxpayer argued that individuals may elect to treat all or any portion of net capital gain as investment income by paying tax on the elected amounts after ordinary income rates under 26 U.S.C. 163(d)(4)(b) and 26 CFR 1.163(d)-1. *MTAB Hrg. Transcr. 40:18-24*. The election must be made on Form 4952 on or before the date of the return for the tax year in which the net capital gain for the qualified dividend income is recognized. *Id.* The Taxpayer argues that he was thus allowed to take the deduction for the contribution to his 401(k), but this election does not change the fact that he did not have self-employed earned income. Furthermore, the Internal Revenue Code and Treasury Regulation the Taxpayer relies on for this argument allow a taxpayer to elect to treat certain capital gains as *investment* income. That investment income is then used to determine the limit to which a taxpayer can deduct investment *interest*. This statute and regulation do not authorize a Taxpayer to convert capital gains to *self-employment* income.
133. Taxpayer claimed that the IRS denied the deduction for 2016 on his federal tax return, but later approved it after he sent additional information to the IRS. *MTAB Hrg. Transcr. 41:13-17*. Taxpayer provided a copy of a partial notice showing the IRS was issuing a refund to him for 2016. *Taxpayer Ex. 1*. However, the notice from the IRS presented as evidence was incomplete and did not include an explanation as to why the refund was being issued or even what issue the IRS was auditing in relation to the notice. The IRS notice as admitted into evidence provides no information to support the Taxpayer's claim that the IRS approved the deduction the Taxpayer claimed for the contribution to his retirement account in 2016. Furthermore, the evidence presented by both the Taxpayer and the DOR

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

indicate the deduction was not permissible as the Taxpayer did not earn self-employment income in 2016.

134. Taxpayer was not eligible to deduct contributions made to his self-employed ETA 401(k) because he had no self-employment income from ETA. The income Taxpayer received from the sale of the GIP interest was not related to ETA, so it was not eligible for contributions to the ETA 401(k). Even if GIP had established a 401(k) for the LLC members, the income from the sale of GIP does not qualify as self-employment income and the Taxpayer would not be eligible to make deductible contributions to that 401(k) with that income, had that 401(k) been established. For these reasons, the Board upholds the DOR's audit determination that the deduction of \$53,000 in the 2016 tax year and in the 2017 tax year must be disallowed.

Issue Three: Denial of Mr. Whitehead's investment interest expense deduction

135. Taxpayer claims there was nothing in writing regarding his \$50,000 investment in GIP, which he referred to as a loan. *MTAB Hrg. Transcr. 63:3-8*. He acknowledged receiving a final distribution from GIP of over \$204,000. *Id.* Taxpayer claims that he only tried to deduct the interest on the investment and that the \$50,044 does not include the principle. *MTAB Hrg. Transcr. 64:25-65:11*. However, the memorandum of understanding dated May 9, 2007 and included in ODR Exhibit G and Taxpayer's Exhibit 11 evidences the \$50,000 as an initial capital contribution to the LLC rather than a loan to the LLC. Capital contributions to a partnership or LLC are treated differently from loans under Subchapter K of the Internal Revenue Code and related Treasury Regulations. While the Taxpayer may not be able to deduct interest on the initial capital he contributed to GIP, he may be entitled to deduct a portion of the interest paid on the loan from Countrywide Home Loans which he used to fund his initial capital contribution.

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

136. Taxpayer filed federal Form 4952 with his 2016 Amended Return claiming an investment interest expense deduction of \$50,044 but did not substantiate or explain how he calculated the deduction. *MTAB Hrg. Transcr. 60:17-21*. Taxpayer points to his letter of August 17, 2021, in which he explained that he arrived at this amount by taking his initial \$50,000 investment and multiplying it by 10 years at 10% interest and adding \$44 in costs. *MTAB Hrg. Transcr. 60:21-24*.
137. Taxpayer provided a deed of trust with Countrywide Home Loans showing that he borrowed funds which he later used to contribute to GIP. *MTAB Hrg. Transcr. 60:25-61:3*. He testified that the \$50,000 he used as an investment in GIP came from a \$120,000 line of credit from First National Bank on May 16, 2007, which was later consolidated with the home equity loan of \$289,000 from Countrywide Home Loans on May 25, 2007. *MTAB Hrg. Transcr. 61:24-63:2*. Because the Taxpayer used \$50,000 of the \$289,000 loan as an investment in GIP, he may be entitled to deduct some of the interest he paid on that loan as investment interest expense versus home equity loan interest.
138. The DOR partially accepted the Taxpayer's investment interest expense deduction but did not accept the full \$50,044 deduction. The DOR stated it did not allow the entire amount of the deduction because the records the DOR received did not support the information the Taxpayer provided on Form 4952. *MTAB Hrg. Transcr. 66:20-67:3*. Mr. Merrian testified that if a taxpayer borrows money to invest it in a partnership, when the partnership generates income, the partner may deduct the interest they pay on the amount borrowed to the extent the partnership generated income, per 26 U.S.C. 163. *MTAB Hrg. Transcr. 67:6-14*. In most cases, rental income generated by a partnership is considered passive income under 26 U.S.C. 469, so passive activity loss limitations apply and excess interest that cannot be deducted will be suspended until the partnership generates additional passive

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

income. *Id.* At that time, the suspended excess interest may be deducted to the extent allowed by the passive income generated by the partnership.

139. Mr. Merrian testified that he could not see that the Taxpayer had previously claimed investment interest deductions on past tax returns, nor did Mr. Merrian see that the Taxpayer consistently reported the rental income from his Schedule K-1s. *MTAB Hrg. Transcr. 67:15-25.* During some tax years, GIP reported rental loss, which would mean that no interest deduction could be taken for those years. *MTAB Hrg. Transcr. 68:1-79:19.* Mr. Merrian testified that DOR's Exhibit E contains a table which attempts to match the income the Taxpayer received from GIP with the interest paid on the Countrywide Home loan. *MTAB Hrg. Transcr. 80:17-81:9.* Mr. Merrian noted that the Taxpayer was unable to provide him with any documents showing how much interest the Taxpayer actually paid each year. *Id.* Because the Department received copies of the Form 1098 from Countrywide Home Loans showing interest paid each year, Mr. Merrian used the information provided on these forms in an attempt to reconstruct the amount of interest deduction Taxpayer could have claimed in prior years. *Id.* Mr. Merrian also noted that it appeared there was income reported on Schedules K-1 that was not reported on the Taxpayer's tax returns each year. However, Mr. Merrian used the income reported on the K-1 in his table to calculate how much interest Taxpayer *may* have been able to deduct over the years even though it appeared in many cases that income was not reported on his tax returns. *Id.* Based on the table, Mr. Merrian determined that Taxpayer *may* have been entitled to a deduction of \$18,507 for the interest on that loan and allowed the Taxpayer to take that deduction in an attempt to be conciliatory. *Id.* The DOR could have disallowed the entire deduction because there was no substantiation for the deduction. *MTAB Hrg. Transcr. 81:10-14.*

140. Taxpayer testified that he believes that DOR believes GIP was paying for his \$289,000 home refinance loan. *MTAB Hrg. Transcr. 61:5-22.* Taxpayer claimed that DOR did not ask

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

him what the interest paid to Countrywide was for and assumed the loan proceeds were used for the investment in GIP rather than for his personal residence. *MTAB Hrg. Transcr. 81:21-84:4*. Mr. Merrian noted that the DOR's assumption that the interest paid on the Countrywide loan related to the investment in GIP was actually favorable to the Taxpayer because DOR could have denied the entire investment interest expense deduction. *Id.* DOR was willing to overlook the fact that not all income shown on the Schedules K-1 each year was reported on the Taxpayer's tax returns. DOR also made assumptions favorable to the Taxpayer regarding the interest paid on the Countrywide loan, assumptions which allowed the Taxpayer to claim a deduction of \$18,507. The Board notes this allowance was made even though the Taxpayer's entitlement to take the deduction was not substantiated and that the DOR could have disallowed the entire deduction. Although the investment interest deduction of \$18,507 was not substantiated, the Board allows it to stand. However, the Board upholds the DOR's determination that the remaining investment interest expense was not deductible.

Issue Four: Denial of \$53,000 self-employment retirement deduction for 2017

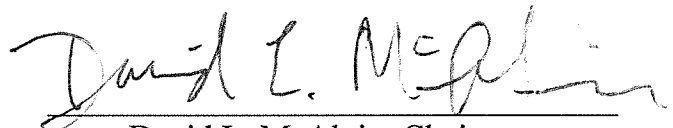
141. The Taxpayer brought forth new "Issue D" at the hearing which he described as the \$53,000 deduction for contributions to a self-employed retirement account which he claimed on his 2017 tax return. *MTAB Hrg. Transcr. 85:9-88:8*. Although the Taxpayer separated out a new Issue D, the Board deems this issue fully considered and discussed as part of Issue B.
142. DOR provided copies of the Order from the United States Tax Court dismissing Taxpayer's appeal for Tax Year 2017 for lack of jurisdiction because Taxpayer must exhaust his administrative remedies before the IRS before proceeding to tax court. *MTAB Hrg. Transcr. 92:17-22; Dept. Ex. U.*

Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

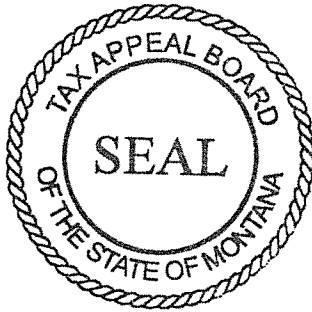
ORDER


We find for the DOR and uphold the final agency decision as it relates to the Taxpayer's income audit for 2016 and 2017 that tax, penalties, and interest accruing from such audit adjustment are properly due and owing.

Dated this 24th day of January 2022.

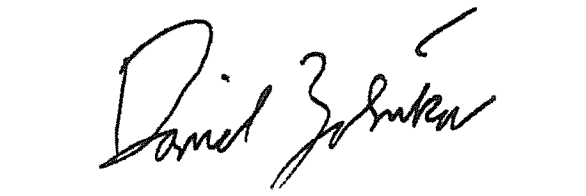


David L. McAlpin, Chairman





Amie Zendron, Member



Daniel Zolnikov, Member

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). 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).

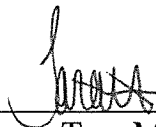
Before The Montana Tax Appeal Board
PURNAL D. WHITEHEAD v. STATE OF MONTANA, DEPARTMENT OF
REVENUE

Certificate of Service

I certify that I caused a true and correct copy of the foregoing Findings of Fact, Conclusions of Law, Order, and Opportunity for Judicial Review to be sent by email and by United States Mail via Print & Mail Services Bureau of the State of Montana on January 24, 2022, to:

Mr. Purnal Whitehead
620 Steel Bridge Road
Kalispell, MT 59901

Teresa G. Whitney, Kristina K. Warren
Montana Department of Revenue
P.O. Box 7701
Helena, MT 59604-7701



Tara M. Green, Legal Secretary