STATE OF MICHIGAN

COURT OF APPEALS

HARRY FRUEHAUF, III, and SHEILA FRUEHAUF,

Plaintiffs-Appellees/Cross-Appellants,

v

DEPARTMENT OF TREASURY,

Defendant-Appellant/Cross-Appellee.

UNPUBLISHED
October 8, 1999

No. 208590
Michigan Tax Tribunal
MTT No. 00233268

HARRY FRUEHAUF, JR., and JANET A. FRUEHAUF,

Plaintiffs-Appellees/Cross-Appellants,

v

DEPARTMENT OF TREASURY,

Defendant-Appellant/Cross-Appellee.

No. 208661
Michigan Tax Tribunal
MTT No. 00233271

Before: Holbrook, Jr., P.J., and Zahra and J.W. Fitzgerald,* JJ.

PER CURIAM.

In these consolidated cases, defendant Department of Treasury appeals as of right from a tax tribunal order holding that plaintiff-taxpayers' gross oil and gas proceeds were subject to severance tax, MCL 205.301 *et seq*.; MSA 7.351 *et seq*., but exempt from income tax, MCL 206.1 *et seq*.; MSA 7.557(101) *et seq*. Plaintiffs cross-appeal from the tribunal's determination that certain capital gains resulting from the sale of oil and gas producing assets were subject to Michigan income tax. We affirm in part and reverse in part.

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* Former Supreme Court justice, sitting on the Court of Appeals by assignment.

The relevant facts were stipulated by the parties. Plaintiffs were oil and gas producers during tax years 1990 through 1993. They filed Michigan tax returns for those years, paying severance tax measured by the gross market value of the oil and gas produced, MCL 205.303; MSA 7.353, as well as income tax. Following this Court's decision in *Bauer v Dep't of Treasury*, 203 Mich App 97; 512 NW2d 42 (1993)—which held that, pursuant to § 15 of the severance tax act, MCL 205.315; MSA 7.365, the severance tax on gross oil and gas proceeds is paid in lieu of income tax—plaintiffs filed amended tax returns for the years 1990 through 1993, reducing their Michigan taxable incomes by the amount of gross oil and gas receipts that were subject to the severance tax. By letter dated June 12, 1995, defendant informed plaintiffs that it was reducing the amount of their claimed refunds on the basis that plaintiffs' taxable incomes should have been reduced by their net, not gross, oil and gas proceeds. The letter did not inform plaintiffs of their right to appeal defendant's decision.

In addition to adjustments relative to the severance tax, plaintiffs sought additional refunds for tax year 1993 on the basis that capital gains realized from the recapture of oil and gas related expenses such as depreciation, depletion, and intangible drilling costs were not subject to Michigan income tax. Plaintiffs Harry Jr. and Janet Fruehauf requested an additional refund of $232,838, and Harry III and Sheila Fruehauf requested an additional refund of $78,749. Plaintiffs contended that they had realized no capital gain for purposes of Michigan income tax because they were precluded from claiming the deductions associated with oil and gas income. By separate letters dated March 14, 1996, defendant informed plaintiffs that their requested refunds were disallowed pursuant to Treasury Revenue Administrative Bulletin (RAB) 1996-1. The letters expressly informed plaintiffs of their right to appeal pursuant to §§ 21 and 22 of the revenue act, MCL 205.1 *et seq.*; MSA 7.657(1) *et seq*.

Plaintiffs filed a timely petition with the tax tribunal, addressing only the capital gains issue. Following a determination by the Court of Claims in *Elenbaas v Dep't of Treasury* that oil and gas production expenses are deductible in calculating Michigan income tax, plaintiffs filed protective income tax returns for the affected tax years, and also sought to amend their original petitions to challenge defendant's earlier decision exempting plaintiffs' net, rather than gross, oil and gas proceeds from income tax. Defendant's untimely reply challenged, among other things, the tribunal's jurisdiction to address the gross-versus-net issue, asserting that the department had not yet acted upon plaintiffs' protective returns.

The tribunal held, consistent with *Bauer, supra,* that "[t]he severance tax is paid on the gross amount of the royalties and that gross amount shall be excluded from taxable income." With regard to the gross-versus-net issue, the tribunal rejected defendant's jurisdictional challenge. With regard to the capital gains issue, the tribunal held that capital gains from the sale of real and personal property, recognized from the recapture of depreciation, amortization, and intangible drilling costs on plaintiffs' federal tax returns, are subject to Michigan income tax. Defendant appealed in Docket No. 208590, and plaintiffs cross appealed in Docket No. 208661.

Docket No. 208590

As it has done repeatedly since this Court's decision in *Bauer, supra,* defendant asks this Court to revisit the issue whether income from oil and gas activities that is subject to severance tax is exempt from income tax. We again decline defendant's invitation, noting that *Bauer* was recently reaffirmed in *Cook v Dep't of Treasury,* 229 Mich App 653, 656; 583 NW2d 696 (1998), and the conflict resolution opinion in *Elenbaas v Dep't of Treasury,* 235 Mich App 372; 597 NW2d 271 (1999).

Next, defendant argues that the tribunal erred in holding that plaintiffs' gross oil and gas proceeds, as opposed to net proceeds, were exempt from income tax. We find no error. In *Elenbaas, supra* at 376, the conflict resolution panel adopted the earlier *Elenbaas* panel's analysis of this issue.[1] In the prior (now vacated) opinion, *Elenbaas v Dep't of Treasury,* 231 Mich App 801, 804-805; 585 NW2d 305 (1998), the panel had explained as follows:

> Defendant next argues . . . that the trial court incorrectly determined that the amount of gross receipts, and not the net income, was exempt from income tax. We disagree. The severance tax is paid on the value of the gross amount of production of gas and oil as computed immediately after the severance. MCL 205.303; MSA 7.353. See also *Fruehauf v Dep't of Treasury*, 9 MTTR 536 (1997), aff'd 10 MTTR 79 (1997). It appears that the goal of § 15 is to exempt that which has already been taxed under the severance tax act. If gross receipts are taxed under the severance tax act, then it necessarily follows that gross receipts, not net income, are exempt from taxation under the ITA. The Tax Tribunal reached a similar result. *Fruehauf, supra* at 9 MTTR 540. Such an interpretation gives effect to the clear language of § 15, which states that the severance tax is to be paid "in lieu of all other taxes." Moreover, a recent panel of this Court recognized that under *Bauer*, oil and gas gross proceeds are no longer subject to state income taxation. *Cook v Dep't of Treasury*, 229 Mich App 653; 583 NW2d 696 (1998). To reach the result proposed by defendant would require judicial modification of the statute.
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> We also note that if gross income is decreased by expenses to arrive at net income, which would constitute the exemption, the resulting taxable portion of income would be based on expenses. Income tax is not to be assessed on expenditures made. Rather, income tax is intended to be assessed upon the income of a person. *Davis v Dep't of Treasury*, 124 Mich App 222, 227; 333 NW2d 521 (1983). Thus, we find defendant's argument, that net income is the only amount subject to the exemption and that expenses should be taxed as income, to be without merit. Plaintiffs were entitled to an exemption of the gross receipts from the production of oil and gas. [Footnote omitted.]

Besides the fact that we are bound by the above holding in *Elenbaas,* we agree with its reasoning and the result reached. Accordingly, the tribunal did not err in holding that plaintiffs' gross oil and gas proceeds were exempt from income tax.[2]

Docket No. 208661

On cross appeal, plaintiffs argue that the tribunal erred in holding that capital gains, recognized from the recapture of depreciation, depletion, and intangible drilling costs, resulting from the sale of certain oil and gas producing assets, were subject to Michigan income tax. We agree and reverse as to this issue.

Again, *Elenbaas* is instructive, if not dispositive, of this issue. The *Elenbaas* conflict resolution panel held as follows, at pp 375-376:

> The conflict at issue is over whether plaintiffs were entitled to deduct oil and gas expenses when calculating their 1993 Michigan income tax or to include those expenses when calculating their net operating loss for Michigan income tax purposes. The *Cook* panel held that subsection 265(a)(1) of the federal Internal Revenue Code[1] generally applies, under subsection 2(3) of the Michigan Income Tax Act (ITA),[2] to prevent taxpayers from deducting expenses related to exempt classes of income. The prior *Elenbaas* panel disagreed, noting that plaintiffs were entitled to deduct oil and gas production expenses when calculating their federal adjusted gross income and that oil and gas receipts are taxed in Michigan under the severance tax act, MCL 205.301 *et seq.*; MSA 7.351 *et seq.*
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> Following an order by the Court of Appeals en banc invoking the conflict resolution procedure of MCR 7.215(H)(3)-(6), this case was reconsidered by this special panel. After due consideration, we are persuaded that the *Cook* panel reached the correct result. We therefore hold that the trial court erred in finding that plaintiffs were entitled to deduct the expenses associated with oil and gas production in computing a net operating loss for the reasons set forth in *Cook*.[3] In all other respects, we adopt the opinion of the prior *Elenbaas* panel as our own.
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> [1] 26 USC 265(a)(1).
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> [2] MCL 206.2(3); MSA 7.557(102)(3).
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> [3] The prior *Elenbaas* panel and our dissenting colleagues disagree with *Cook* in part because oil and gas gross receipts are taxed under the severance tax act. We are not convinced by this argument. Section 2(3) of the ITA does not say that, after considering all available Michigan tax schemes, Michigan taxpayers should be treated the same as they would under the federal tax scheme. Instead, § 2(3) clearly states that "the income subject to tax [shall] be the same as taxable income as defined and applicable to the subject taxpayer in the internal revenue code." MCL 206.2(3); MSA 7.557(102)(3). We therefore conclude that the taxation of a taxpayer under a different scheme, such as the severance tax act, is irrelevant.

In adopting the *Cook* panel's holding that 26 USC 265(a)(1) generally applies, under subsection 2(3) of the ITA, to preclude taxpayers from deducting expenses related to exempt classes of income, the *Elenbaas* panel concluded that the plaintiff-taxpayers were not entitled to deduct their oil and gas production expenses in computing a net operating loss for tax year 1993. To the extent that the

Elenbaas panel's holding can be read as limited to situations involving the calculation of a net operating loss, we would expand it to apply also in situations involving the calculation of Michigan income tax liability on net income. That is, where a taxpayer's gross oil and gas proceeds are wholly exempt from Michigan income tax, no deductions for production expenses, such as depreciation, depletion, and intangible drilling costs, are allowed. Consequently, where no deductions are taken for oil and gas production expenses, there can be no "recapture" of such expenses once the taxpayer disposes of an oil and gas producing asset such that a capital gain would be taxable as ordinary income under the Michigan ITA. *Elenbaas, supra* at 375-376.

Affirmed in No. 208590, and reversed in No. 208661.

/s/ Donald E. Holbrook, Jr.
/s/ Brian K. Zahra
/s/ John W. Fitzgerald

[1] Three issues were raised and decided in the prior *Elenbaas* opinion, only one of which created a conflict with *Cook, supra,* i.e., whether the plaintiff-taxpayers were entitled to deduct the expenses associated with oil and gas production in computing a net operating loss for tax year 1993. As noted by the conflict resolution panel in *Elenbaas, supra* at 376 n 3, the fact that the plaintiff-taxpayers were subject to severance tax on their oil and gas proceeds was "irrelevant" to the determination whether they were entitled to deduct oil and gas production expenses in calculating their Michigan income tax liability.

[2] With regard to defendant's claim that the tribunal lacked jurisdiction to consider the gross-versus-net issue because plaintiffs did not timely file an appeal from defendant's June 12, 1995, letter reducing their claimed refunds, we conclude that the issue is moot. The gross-versus-net issue was definitively decided in *Elenbaas, supra,* and is binding on the parties and this panel.