

IN THE OREGON TAX COURT
MAGISTRATE DIVISION
Income Tax

MICHAEL J. FOOTE,)	
)	
Plaintiff,)	TC-MD 050432C
)	
v.)	
)	
DEPARTMENT OF REVENUE,)	
State of Oregon,)	
)	
Defendant.)	DECISION

Plaintiff appeals Defendant’s personal income tax assessment and refund denial for tax year 1998. The matter was presented to the court on stipulated facts and opposing briefs for summary judgment. Oral argument was held in the courtroom of the Oregon Tax Court June 7, 2006. Plaintiff was represented by Stephen B. Hill and Darin Christensen, attorneys at law, Bullivant Houser Bailey P.C. Defendant was represented by Jerry Bronner, Assistant Attorney General. With him on brief was Hardy Myers, Attorney General, State of Oregon.

I. STATEMENT OF FACTS

The following facts have been stipulated or appear in documents filed by the parties.

Plaintiff became an Oregon resident in late 1996. (Stip Fact 1.) Plaintiff was a resident of California prior to becoming an Oregon resident. (Stip Fact 2.) During the time Plaintiff was a California resident, he was the sole shareholder of several S corporations, including Hidden Hills of Escondido, Inc.(Hidden Hills), which was renamed Rock Bottom Development (Rock Bottom) after Plaintiff became a resident of Oregon. (Stip Fact 3.)

In 1995, while Plaintiff was a resident of California, his wholly-owned California S corporation, Hidden Hills, realized \$1,039,231 of discharged indebtedness. (Stip Facts 3, 5.)

///

That same year, Rock Bottom also had a \$661,039 Internal Revenue Code (IRC) section 1231 loss and suspended losses from 1994 and earlier in the amount of \$390,084. (Stip Ex A at 5.)

Pursuant to federal tax law, the discharged debt, although excluded from the gross income of Rock Bottom (and Plaintiff) under IRC sections 108(a) and 108(d)(7)(A) because Rock Bottom was insolvent, was, nevertheless, “an item of income” that passed through to Plaintiff and increased his basis in the stock of Rock Bottom and his basis in the debt owed him by Rock Bottom by \$1,039,231. (Stip Facts 12, 13.) *See Gitlitz v. Commissioner of Internal Revenue*, 531 US 206, 121 SCt 701 (2001). Plaintiff’s increased basis resulted in the pass-through of the suspended losses, the IRC section 1231 loss, and two other items for purposes of Plaintiff’s 1995 federal taxable income. (Stip Facts 14,15.) Pursuant to *Gitlitz*, and as a result of the pass-through of those losses, Plaintiff’s federal adjusted basis in the stock and debt owed him by Rock Bottom was required to be reduced to zero and \$27,730, respectively. (Stip Fact 16.)

Because the above allowable deductions exceeded Plaintiff’s income for tax year 1995, Plaintiff realized, for purposes of federal taxable income, a net operating loss (NOL) in 1995 that was equal to the amount of the excess. The parties agree Plaintiff’s 1995 federal NOL carryforward “should have been increased by the \$661,039 section 1231 loss and the suspended losses * * * of \$390,084.” (Stip Fact 16.)

Because of uncertainty about the law concerning the ordering rules for adjusting basis, for purposes of his 1995 federal income tax return, Plaintiff increased his basis in the stock of Rock Bottom by the amount of the excluded discharged debt, but did not reduce his basis for the pass-through of the suspended losses and the section 1231 loss, or claim a deduction for those

///

///

///

losses. (Stip Fact 7.) As discussed above, federal tax law required that Plaintiff's stock basis be reduced to zero as a result of the pass-through of the suspended losses and the section 1231 loss.¹

Plaintiff's 1998 Oregon income tax return reported a taxable loss of \$777,512 from line 33 of Plaintiff's 1998 federal form 1040, which resulted in an Oregon taxable loss of \$818,787. (Ptf's Opening Br at 1; Stip Ex A at 1; Stip Ex E at 1, 2.) Plaintiff's 1998 federal return reported a current year (1998) ordinary loss of \$385,328 generated by Rock Bottom and a non-Oregon source NOL carryforward in the amount of \$182,643.² (Ptf's Opening Brief at 1; Stip Ex E at 8; Stip Fact 8.) Plaintiff's 1998 Schedule K-1 also reported a distribution from Rock Bottom of \$343,165. (Stip Ex A at 7.)

The Auditor's Report issued by Defendant with respect to Plaintiff's 1998 Oregon return disallowed the NOL carryforward because it was a non-Oregon source loss incurred before Plaintiff became an Oregon resident. (Stip Ex A at 10; Stip Fact 9.) And, because of insufficient basis, the auditor disallowed most of the pass-through of Rock Bottom's 1998 operating loss (allowing only \$66,561 of the \$385,328 generated in 1998) and recharacterized most of Plaintiff's 1998 distribution of \$343,165 from Rock Bottom as taxable income. (Stip Facts 9, 11; Stip Ex A at 6; Def's Resp at 2.) As a result of those adjustments, Defendant determined that Plaintiff had Oregon taxable income in 1998 of \$491,308. (Stip Ex A at 14.) Consequently, Defendant assessed Oregon income taxes for 1998 in the amount of \$41,636, plus interest. Plaintiff paid those amounts and now seeks a refund. (See Ptf's Compl at 1.)

¹ *Giltz* clarified the timing issue, providing that basis is increased for discharge of indebtedness involving an insolvent S corporation before, and not after, losses are addressed. Based on the then-current understanding of the law (prior to *Giltz*), Plaintiff apparently did not reduce basis or claim the deduction because he addressed losses before increasing basis for the discharged debt, and, under that interpretation of the law, he had insufficient basis to claim the losses. (See Ptf's Opening Br at 2.)

² The return also claimed a business bad debt deduction in the amount of \$452,066, which Defendant denied. That adjustment is not at issue here. (Stip Ex A at 1.)

Plaintiff agrees that under the 2001 Supreme Court decision in *Gitlitz*, his only basis in his Rock Bottom stock as of January 1, 1998, was \$66,561. (Ptf's Opening Br at 2.) Plaintiff further agrees that this court's decision in *Zemke v. Dept. of Rev.*, 17 OTR 18 (2003), "requires that the net operating losses which taxpayer carried forward from tax years when he was a resident of California be disallowed as a deduction against his taxable income in 1998." (Ptf's Opening Br at 5.) However, Plaintiff contends that "*Zemke* also requires that those disallowed net operating losses which arose from the operation of Rock Bottom be restored to the basis of taxpayer's Rock Bottom stock and debt pursuant to ORS 316.716(1)(e) and ORS 316.716(2)."

Id. According to Plaintiff:

"If the basis of taxpayer's debt and stock was restored to the extent of the disallowed 1998 net operating loss carryforward arising from losses of Rock Bottom, taxpayer (i) would have no income from the \$340,281³ in distributions received by taxpayer in 1998, (ii) would be entitled to a full deduction of the 1998 losses of Rock Bottom, and (iii) would have sufficient capital losses to offset any capital gains in 1998. As a result, taxpayer would have no taxable income in 1998 and would therefore be entitled to a full refund of all income taxes and interest paid by the taxpayer for 1998."

(Ptf's Opening Br at 3.)

II. ANALYSIS

The issue in this case is whether the non-Oregon source losses incurred by Plaintiff before he became an Oregon resident, and which reduced Plaintiff's federal basis in his Rock Bottom stock and debt, must be restored to basis, pursuant to ORS 316.716(1)(e) and (2),⁴ and the principals enunciated in *Zemke*.

///

³ According to Stipulated Exhibit A, pages 6 and 7, the 1998 Schedule K-1 distribution was \$343,165. During the audit, Defendant allowed \$2,884 as a nontaxable return of capital, thereby deeming the taxable portion of the distribution to be \$340,281.

⁴ All references to Oregon Revised Statutes are to 1997.

The taxpayer in *Zemke* had downward adjustments to the basis of a California property stemming from depreciation deductions, including those taken during a period of the taxpayer's California residency. *See Zemke*, 17 OTR at 20. The taxpayer sold the property at a gain after becoming an Oregon resident. *See id.* The court upheld the department's disallowance of the taxpayer's claimed NOL carryforward deduction because the losses had no Oregon source in the year of generation (*i.e.*, the losses in the California property were incurred prior to taxpayer's Oregon residency). *See id.* at 22, 23.⁵ It is that portion of the *Zemke* decision (and ORS 316.014) that precludes Plaintiff from deducting his non-Oregon source NOLs. Plaintiff acknowledges that fact.

Plaintiff insists, however, that *Zemke* and ORS 316.716 require a restoration of Plaintiff's basis because his basis was reduced by non-Oregon source NOLs carried forward to 1998 and disallowed by Oregon. Plaintiff contends that the disallowed non-Oregon source losses constitute a difference in basis stemming from a difference between federal and Oregon tax law. Keying on language in *Zemke*, Plaintiff argues that "it would be inequitable for Oregon to take the benefit of the basis reduction to the Rock Bottom debt and the stock produced by the Rock Bottom losses without ever permitting such losses to yield an Oregon tax benefit. Therefore, ORS 316.716(1)(e) and ORS 316.716(2) must be read to require the increase in basis to the extent of the disallowed losses of Rock Bottom." (Ptf's Opening Brief at 4, 5.)

///

⁵ The court's decision was based on *Lufkin v. Dept of Rev.*, 11 OTR 410 (1990) and the language in ORS 316.014(2), which, for the year at issue, provided:

"In the case of a nonresident, the net operating loss deduction, net operating loss carryback and net operating loss carryforward shall be that described in subsection (1) of this section *which is attributed to Oregon sources.*"

ORS 316.014(2) (emphasis added).

Defendant disagrees, arguing that Plaintiff's Oregon basis is the same as his federal basis because there is no Oregon statute or administrative rule that specifically provides for a stock and debt basis different than the federal basis. Defendant insists that the basis adjustment rules applicable to *Zemke* do not apply because they pertained to depreciation of a tangible asset (depreciable property), and neither *Zemke* nor the basis adjustment rules applicable to that case "have any application to plaintiff's basis in his stock and debt." (Def's Resp at 5.)

ORS 316.716 provides:

"(1) Upon the taxable sale, exchange or disposition of any asset * * * *federal taxable income* shall be increased or decreased by an amount which will reflect one or more of the following:

" * * * * *

"(e) Any other differences in the basis of the asset which are due to differences between federal and Oregon tax law."

(Emphasis added.)

When "interpreting a statute, the court's task is to discern the intent of the legislature." *PGE v. Bureau of Labor and Industries*, 317 Or 606, 610, 859 P2d 1143 (1993). The first level of analysis includes consideration of the text and context of the particular statutory provision at issue, aided where necessary by the application of rules of statutory construction. *See id.* at 610, 611. Among the rules of construction are the statutory enjoiner that the court " 'not to insert what has been omitted, or to omit what has been inserted,' " and the judicially-created rule that "words of common usage typically should be given their plain, natural, and ordinary meaning." *Id.* at 611.

The text of ORS 316.716(1)(e) is unclear and lends itself to various interpretations, as evidenced by the disparate positions of the parties. Giving the words of the statute their "plain, natural, and ordinary meaning[,]" it is clear to the court that the statute provides for an

adjustment to federal taxable income. It is also clear that the adjustment to income occurs upon the disposition of the asset.⁶ However, those observations do not resolve the present dispute. The problem is that it is not clear what is meant by the phrase “differences in the basis of the asset[.]” ORS 316.716(1)(e).

Basis is determined by federal and state tax codes. Under the federal tax code, the shareholder of a qualified Subchapter S corporation increases stock and debt bases for items of income under IRC section 1367(a)(1), and decreases (but not below zero) those bases for certain distributions, losses and deductions pursuant to section 1367(a)(2). Oregon specifically provides for a separate basis determination in only very limited situations.⁷ However, there is no specific Oregon statute or regulation that provides for a different basis where losses (other than from depreciation) carried forward from an earlier year are denied by Oregon because of their non-Oregon source generated prior to the taxpayer’s Oregon residency (which is the situation at hand). That is, unless ORS 316.716(1)(e) provides for a different basis. That is an open question.

The context of the ORS 316.716 (1)(e) does not fully resolve the question of legislative intent. Subsection (1) provides generally for an adjustment to federal taxable income, and paragraphs (a) through (e) set forth the circumstances when the adjustment is required. They all refer to a “difference in basis,” and are triggered by some difference between federal and Oregon tax law. For example, subsection (1)(b) requires an adjustment to federal taxable income where

///

///

⁶ Defendant contends that the statute only applies to tangible assets, but the court finds no such limitation in the language of the statute.

⁷ For example, ORS 316.707, and the rules promulgated thereunder, provide for a separate determination of basis when there are differences between federal and Oregon depreciation.

there is a “difference in basis which results when a taxpayer has taken a federal credit [requiring a reduction to basis], and the federal credit is not allowable for Oregon tax purposes[.]”⁸ Yet, there is no separate statute or regulation specifically providing for a determination of basis different from the federal code for that situation or the others listed under ORS 316.716(1).

If Defendant is correct in its assertion that an adjustment to income under ORS 316.716 is contingent upon a separate statute or rule specifically providing for an adjustment to basis, and there are no such provisions in the law, then subsection (1) of the statute is rendered a nullity, and the intent of the legislature, whatever it may be, is completely thwarted.

When the legislature’s intent is not clear from the text and context of the statute, the court considers any relevant legislative history that might shed light on that intent. *See PGE*, 317 Or at 610. The legislative history from the subcommittee hearings reveals that the legislature intended there to be an adjustment to taxable income where there are differences in federal and state bases for any of the reasons set forth in paragraphs (a) through (e) of the statute, and that the difference in basis was presumed to exist. *See generally*, Testimony, House Committee on Revenue and School Finance, Subcommittee on Income Tax, HB 2011, Apr 11, 1985, Tape 165, B. For example, when speaking of a federal investment credit that reduces basis, and which Oregon does not allow, Representative Schoon spoke of two schedules, one federal and one state, and commented that “[t]he original basis is not the same for state purposes as for federal because we do not allow the investment tax credit.” *Id.* (Emphasis added.) A Department of Revenue witness at that hearing testified that “this isn’t adjusting the basis at the end. What this is doing – this is adjusting the gain or loss on the disposition of the asset.” *Id.* (testimony of Gary Mollgaard). The rationale for the adjustment to federal taxable income is that

⁸ Paragraph (c) pertains to differences in basis resulting from federal and state differences in the treatment of deferral of gain. Paragraph (d) provides for an adjustment to federal taxable income where there is a “difference in basis under federal and Oregon tax law at the time the asset was acquired [.]”

the Oregon return starts with federal taxable income, which in turn is based on federal basis determinations, and, without an adjustment, Oregon would receive a windfall by taxing a gain based in part on disallowed deductions. As stated by the court in *Zemke*, 17 OTR at 27, “Oregon would take the benefit of the basis reduction to property produced by the [loss] deductions without ever permitting [those] deductions to yield a tax benefit.”

The court concludes that the legislative history reveals an intent that there be an adjustment to federal taxable income where there exists a difference in basis because of a difference between federal and Oregon tax law, including the situation here at issue.

ORS 316.716(1)(e) requires such an adjustment because Plaintiff had non-Oregon source losses prior to becoming an Oregon resident, losses that reduced federal basis, and that were carried forward to a year of residency, which are not allowed as a deduction under Oregon law. The disallowed losses must be restored to basis for purposes of determining the appropriate adjustment to federal taxable income (AGI) on Plaintiff’s 1998 Oregon return.⁹ Such a result “ameliorates what would otherwise be a patently harsh result for a person moving from state-to-state.” *Zemke*, 17 OTR at 27.

The principle embodied in ORS 316.716 is the tax benefit rule, a judicially developed doctrine codified, in part, in IRC section 111. The exclusionary component of that rule requires a taxpayer to include income only to the extent the deduction gave rise to a tax benefit. *See Hillsboro Nat’l Bank v. CIR*, 460 US 370, 75 L Ed 2d 130 (1983).¹⁰ The tax benefit rule was the

///

⁹ Line 8 of Plaintiff’s 1998 Oregon Form 40. (Stip Ex F at 1.)

¹⁰ “The Supreme Court, in the *Hillsboro National Bank* case, established the standard that the tax benefit rule is applied when a subsequent event occurs which is ‘fundamentally inconsistent with the premise on which (an earlier) deduction was based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction.’ ” 1 Mertens Law of Fed. Income Tax’n § 7:26

basis for relief in *Bello v. Commissioner of Revenue*, 11 ConnLRptr 339 (1994), where certain S corporation shareholders were not required to reduce their basis for losses recognized at the federal level because Connecticut had no personal income tax and consequently no tax against which to deduct the passed-through losses (i.e., no state tax benefit). In *Koch v. Director, Div. of Taxation*, 157 NJ 1, 722 A2d 918 (1999), the New Jersey Supreme Court in effect applied a tax benefit rule, agreeing that to the extent that a taxpayer incurred no economic gain on the sale of a partnership interest, he was not required for New Jersey Personal Income Tax purposes to reduce his basis in partnership interest by partnership losses that produced no New Jersey tax benefit.

As a final matter, the court rejects Defendant's contention that, if the basis adjustment rules applicable to *Zemke* apply, a \$1,039,231 reduction to Plaintiff's basis is required to offset the increase that occurred in 1995 as a result of the discharged debt. (Def's Resp at 4, 5,10.) Defendant contends that the adjustment is necessary because the basis adjustment rules applicable to *Zemke* began with federal unadjusted basis rather than adjusted basis. (*Id.* at 4, 5.) The problem with that contention is that the court is not applying the basis adjustment rules discussed in *Zemke*, but is instead applying ORS 316.716(1)(e).

III. CONCLUSION

The court concludes that Plaintiff cannot be taxed by reference to a federal adjusted basis reduced for losses disallowed by Oregon. ORS 316.716(1)(e) requires an adjustment to federal taxable income for purposes of Plaintiff's 1998 Oregon return, calculated by reference to a basis adjusted to remove the non-Oregon source NOLs carried forward to 1998 and disallowed by Oregon. Now, therefore,

///

///

///

IT IS THE DECISION OF THIS COURT that Plaintiff's appeal is granted in accordance with the court's Decision as set forth above.

Dated this _____ day of November 2006.

DAN ROBINSON
MAGISTRATE

If you want to appeal this Decision, file a Complaint in the Regular Division of the Oregon Tax Court, by mailing to: 1163 State Street, Salem, OR 97301-2563; or by hand delivery to: Fourth Floor, 1241 State Street, Salem, OR.

Your Complaint must be submitted within 60 days after the date of the Decision or this Decision becomes final and cannot be changed.

This document was signed by Magistrate Dan Robinson on November 14, 2006. The Court filed and entered this document on November 14, 2006.