STATE OF MAINE
KENNEBEC, ss.

MAINE BOARD OF TAX APPEALS
DOCKET NO. BTA-2013-8

[INDIVIDUAL TAXPAYERS],

Petitioners

v.

DECISION

MAINE REVENUE SERVICES,

Respondent

I. Background

[Individual Taxpayers] (the "Taxpayers") appeal from an assessment of individual income tax made by Maine Revenue Services ("MRS") for tax year 2011. An Appeals Conference was held on [date], at which the [Taxpayers], who did not attend, were represented by [Representative], MRS was represented by [MRS Representative], and Appeals Officer [ ] presided.

The sole issue presented on appeal is whether, in computing their 2011 Maine income tax liability, the federal "tax benefit rule" should be invoked to reduce the Taxpayers' Maine income tax liability. The Taxpayers have the burden of proof to show that it is more likely than not that MRS erred in making the assessment. 36 M.R.S. § 151-D(10)(F).

II. Facts

At all relevant times, the [Taxpayers] were residents of the State of [other state]. In [year of purchase], [the Taxpayers] purchased an interest in the [Business], a [non-Maine pass-through entity] doing business in Maine [ ]. In 2011, [Taxpayers] and the other owners sold the Business for [sale price], and, according to information provided on the Taxpayers' 2011 federal income tax return, [Taxpayers] recognized a net long-term capital gain of [gain amount] on the sale.

Also on that return, the Taxpayers reported current-year Business losses totaling [amount] and prior-year Business net operating losses (“NOLs”) of [prior-year NOL amount] that the Taxpayers carried-forward to 2011 from 2010. For the period at issue, the Taxpayers derived all of their Maine source income from the Business. The Taxpayers timely filed a 2011 Maine income tax return, reporting estimated tax payments of [estimated payments], a Maine income tax liability of [liability amount], and an overpayment credit of [overpayment amount] for which a refund was requested. On audit, MRS recomputed the Taxpayers’ Maine liability and issued an assessment for [ ] additional tax and interest.

III. Law

Under federal law, NOLs are allowed to offset other income, resulting in a tax savings. I.R.C. § 172(a). NOLs cannot, however, be used to reduce taxable income to below zero. Instead, the law allows unused NOLs to be taken in other tax years. *Id.* § 172(b)(2). If a partnership incurs a loss in a given year, that loss is passed through to the partners, and the adjusted basis of the partner’s interest is reduced to the extent of the passed-through loss, but not below zero. *Id.* § 705(a)(2)(A).

Under Maine income tax law, “a tax is imposed for each taxable year on the Maine adjusted gross income of every nonresident individual.” 36 M.R.S. §5111(4). The starting point for determining Maine adjusted gross income is the federal adjusted gross income amount appearing on a taxpayer's federal income tax return for a given year. 36 M.R.S. § 5102(1-C). For a nonresident, “‘Maine adjusted gross income’ means . . . that part of his federal adjusted gross income derived from sources within this State,” *id.* § 5102(1-C)(B), plus “[t]he portion of the modifications described in section 5122 . . . that relates to income derived from or connected with sources in this State. . . .” *Id*. § 5142. As relevant to this case, one of the modifications contained in 36 M.R.S. § 5122 is the following:

> 1. Additions. Federal adjusted gross income shall be increased by:
>
> . . . .
>
> DD. For any taxable year beginning in 2009, 2010 or 2011, an amount equal to the absolute value of any net operating loss carry-forward claimed for purposes of the federal income tax;
>
> . . . .

Thus, for the 2009, 2010 and 2011 tax years, any taxpayer claiming an NOL on their federal return that was carried forward from a prior year was required to increase Maine adjusted gross income by the amount of the NOL in computing their Maine tax liability. The Taxpayers, however, are looking to the tax benefit rule as authority for using carryforward NOLs to offset their Maine source income for the period at issue.

The tax benefit rule is a judicially created principle, intended to remedy some of the inequities that would otherwise result from the annual accounting system used for federal income-tax purposes.[1] *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 377 (1983). The tax benefit rule has two components, a rule of inclusion and a rule of exclusion. The inclusion component of the rule requires the taxpayer to recognize income when an event occurs in a later tax year that is fundamentally inconsistent with the premise on which a deduction previously had been based (*e.g.*, recovery in court of a bad debt that was deducted as a loss in a previous tax year). *Hillsboro* at 372. The exclusionary aspect of the tax benefit rule requires the taxpayer to include in income only the amount of the deduction that gave rise to a tax benefit. The portion of the recovery that did not result in a prior tax benefit is excluded from income. *Hillsboro* at 388.

[1] An example of circumstances where strict adherence to an annual accounting system could produce an inequitable result is when a taxpayer, who had incurred a net loss on a contract, managed to recoup the loss in a subsequent lawsuit. Neither the loss nor the recovery would affect the taxpayer's gross income if they both occurred in the same year. Recognizing either the loss or the recovery alone would be inequitable, which may happen if each occurred in different years.

"[T]he tax benefit rule will 'cancel out' an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based." *Hillsboro* at 383. The portion of the tax benefit rule relied upon by the Taxpayers is the exclusionary component as codified at I.R.C. § 111(a), which provides that "[g]ross income does not include income attributable to a recovery during the taxable year of any amount deducted in any prior taxable year to the extent that such amount did not reduce the amount of [income] tax . . . ."[2]

IV. Analysis

The Taxpayers filed their original 2011 Maine nonresident return using the same federal adjusted gross income figure used on their federal return. *See* 18-125 C.M.R. 806 § 7 (Return of Nonresident or Part-year Resident) (repealed and replaced November 12, 2006) ("Rule 806") and 1040ME instructions. That figure included NOLs from the Business in the amount of [prior-year NOL amount] that were carried-forward from 2010. In enacting 36 M.R.S. § 5122(1)(DD), Maine's legislature directed that such carryforward losses would not be allowed for 2009, 2010, and 2011, but must be added-back in computing a resident or nonresident individual's Maine adjusted gross income and Maine tax liability for those tax years.[3] Because the Taxpayers did not add-back the amount of the carryforward NOLs in computing their Maine tax liability, MRS made that adjustment at the conclusion of the audit and recomputed the Taxpayers' Maine liability, resulting in the subject assessment.

[2] For a more in-depth discussion of the tax benefit rule see Bittker & Kanner, The Tax Benefit Rule, 26 UCLA L. Rev. 265 (1978).

[3] Rather than being disallowed in full, the legislature permitted carryforward NOLs to be deferred and taken at a later date. Under 36 M.R.S. § 5122(2)(CC), NOLs accruing prior to 2012 are subject to a subtraction modification to federal adjusted gross income, reducing Maine adjusted gross income and tax liability in 2012 and subsequent years.

In response to the assessment, the Taxpayers filed an amended Maine return showing no Maine income tax liability and requesting a refund of all amounts previously paid. The Taxpayers did not file a corresponding amended federal return. In computing their Maine tax liability on the amended return, the Taxpayers used prior year NOLs, not appearing on their 2011 federal return, to increase their basis in the Business and to thereby reduce their gain on its sale. In explaining the computation of their amended return on appeal, the Taxpayers rely on the New Jersey Supreme Court case of *Koch v. Dir., Div. of Taxation*, 722 A.2d 918 (N.J. 1999), arguing that they are entitled to apply all NOLs, not previously used in Maine to offset Maine-sourced income, against the proceeds of the sale of the Business.

In the *Koch* case, the taxpayers purchased an interest in a partnership for the price of $75,000 and subsequently sold it for $125,000, resulting in a net economic gain of $50,000. At the time of purchase, the taxpayers also received a constructive payment that eliminated the deficit in their capital account, and a release of personal liability for partnership debt. Because of losses deducted in prior years, the taxpayers had no basis in the partnership for federal income tax purposes. Thus, on their federal income tax return in the year of sale, the taxpayers reported the entire amount realized on the sale rather than simply the $50,000 economic gain. On their New Jersey state return, however, because New Jersey income tax law did not provide a deduction for partnership losses, the taxpayers reported only the $50,000 gain from the sale of their partnership interest—the difference between the $75,000 paid for the interest and the $125,000 sale proceeds. The New Jersey Division of Taxation contended that the taxpayers should have reported the same amount of gain for state income tax purposes as they reported for federal income tax purposes, and issued an assessment in that case. On appeal, the taxpayers argued that the federal tax benefit rule precluded the state from imposing an income tax computed using their federal adjusted partnership basis. The court held that the intent of the New Jersey tax law was to tax only economic gain.[4] The court also found that the imposition of tax on any amount above the economic gain would constitute a tax on a return of capital, contrary to the New Jersey statutes. Because the court based its decision on this statutory language, it was unnecessary for it to consider the applicability of the federal tax benefit rule under the facts presented. *Koch.* at 924.

Despite the Taxpayers' reliance, the *Koch* case has no applicability in Maine; Maine tax law contains no provision analogous to the New Jersey statute at issue in *Koch*, which categorized income and then selectively imposed the tax only on net gains. Instead, for Maine nonresidents, Maine imposes a tax on that portion of federal adjusted gross income derived from sources in this state, with the addition and subtraction modifications provided under 36 M.R.S. § 5122. 36 M.R.S. §§ 5102(1-C)(B), 5111(4).[5] The Maine Supreme Court explained the rationale for this system in *Green v. State Tax Assessor,* 562 A.2d 1217, 1220, 1223-24 (Me. 1989) (quoting *Tiedemann v. Johnson*, 316 A.2d at 362-64 (Me. 1974)), where it noted that:

> By adoption of federal adjusted gross income as the standard by which Maine income would be measured, the Legislature purposefully sought to simplify the entire Maine tax assessment and collection system by utilizing a clear objective criterion, and thus

---

[4] As supplied in the *Koch* decision:

> N.J.S.A. 54A:5-1 provides that New Jersey gross income shall consist of fourteen categories. One of those categories is the net gains or income that arise from the disposition of property. That category of income is addressed in section 5-1c which provides in pertinent part,
>
> > **Net gains or income from disposition of property.** Net gains or net income, less net losses, derived from the sale, exchange or other disposition of property, including real or personal, whether tangible or intangible as determined in accordance with the method of accounting used for federal income tax purposes. For the purpose of determining gain or loss, the basis of property shall be the adjusted basis used for federal income tax purposes.

Koch v. Dir., Div. of Taxation, 722 A.2d 918, 920.

[5] Similarly, for Maine residents, Maine imposes a tax on the entire amount of federal adjusted gross income, with the addition and subtraction modifications provided under 36 M.R.S. § 5122. 36 M.R.S. §§ 5102(1-C)(A), 5111.

> avoiding the pits and falls which accompany administrative or judicial inquiries into the 'nature' or 'origin' of particular items of individual income.

The *Green* decision also involved carryforward NOLs and, in part, is analogous to the situation in this case. The nonresident taxpayers in *Green* sought to utilize NOLs accruing in Maine in previous years against subsequent Maine income. The taxpayers had previously deducted these same losses against non-Maine income on their federal returns, but had insufficient Maine income against which to offset the losses.[6] As a result, when the taxpayers claimed these NOLs on their Maine return for the tax year at issue, they were not included on their federal return for the same year (having already been claimed at the federal level). The court held that Maine income tax law prohibits both residents and non-residents alike from deducting carryforward losses if those losses are not also entered on their federal income tax returns for the same tax year. *Id*. at 1220. Maine tax law does not, itself, provide for the carry forward or carry back of net operating losses. Rather, as noted in Rule 806 § 4 (Deduction of Losses), "[a] loss that is deducted in computing the nonresident taxpayer's federal adjusted gross income is automatically included in that taxpayer's Maine adjusted gross income for the same tax year," due to Maine's use of federal adjusted gross income as a starting point. For tax years 2009, 2010, and 2011, however, Maine tax law disallows the use of carryforward losses in computing Maine adjusted gross income, and requires that those losses be added-back to federal adjusted gross income. 36 M.R.S. § 5122(1)(DD).

In the present case, the Taxpayers seek not only to avoid the add-back provision of 36 M.R.S. § 5122(1)(DD) for Business NOLs that were carried forward on both their 2011 federal and original Maine returns, they also seek to obtain the benefit of NOLs that were not reported

[6] Unlike the taxpayers in *Koch* and *Green*, the Taxpayers in the present case are unable to use their Business NOLs in Maine due to *both* insufficiency of Maine income ([year of purchase]-2010) and legislative prohibition (2009-2011).

on their 2011 federal return. Under 36 M.R.S. § 5122(1)(DD), the Taxpayers are precluded from applying carryforward NOLs appearing on their federal income tax return against their Maine tax liability for the period at issue, and under the holding in *Green*, the Taxpayers are precluded from deducting NOLs on their Maine return that were not deducted on their federal return in the same year.

Considering Maine's system of income tax computation as described in *Green*, the Taxpayers have not shown that the federal tax benefit rule has any applicability here, either under Maine law or as applied to this case. The method of computing Maine income tax as set forth under Maine's statutes (*i.e.*, modification of federal adjusted gross income under 36 M.R.S. § 5122 to arrive at Maine adjusted gross income subject to tax under section 5111) leaves no room for the rule. Even if it has applicability in Maine, "[t]he tax benefit rule does not permit the . . . rematch[ing of] properly recognized income with properly deducted expenses; it merely permits a balancing entry when an apparently proper expense turns out to be improper." *Hillsboro* at 389 n. 24. The Taxpayers have not shown that their recognition of gain or loss associated with the Business is in need of such a balancing entry. No adjustment to the assessment is warranted.

V. DECISION

To the extent that the Taxpayers seek to apply carryforward NOLs as stated on their 2011 federal return against their 2011 Maine income, they are foreclosed from doing so. 36 M.R.S. § 5122(1)(DD). They may, however, apply these NOLs to offset income in 2012 and subsequent years as provided by 36 M.R.S. § 5122(2)(CC). To the extent that the Taxpayers seek to apply carryforward losses not stated on their 2011 federal return against their 2011 Maine income, they are foreclosed from doing so. *Green v. State Tax Assessor*, 562 A.2d 1217 (Me. 1989). The

Taxpayers have not shown that the federal tax benefit rule is applicable in determining Maine income tax liability in this case.

Accordingly, we uphold the assessment in full.

The Board may, in limited circumstances, reconsider its decision on any appeal. If either party wishes to request reconsideration, that party must file a written request with the Board within 20 days of receiving this decision. Contact the Appeals Office at 207-287-2864 or see the Board's rules, available at http://www.maine.gov/boardoftaxappeals/lawsrules/, for more information on when the Board may grant reconsideration. If no motion for reconsideration is filed within 20 days of the date of this proposed decision, it will become the Board's final administrative action. If either party wishes to appeal the Board's decision in this matter to the Maine Superior Court, that party must do so within 60 days of receiving this decision. During the 60 day period in which an appeal may be filed with the Superior Court, [Taxpayers] may contact Maine Revenue Services at 207-624-9725 for the amount of tax that is currently due, together with any interest or penalties owed. After that 60 day period has expired, Maine Revenue Services will contact [the Taxpayers] with an updated amount of tax and any interest or penalties due at that time.

Issued by the Board: September 12, 2013