BEFORE THE STATE BOARD OF TAX APPEALS STATE OF ARIZONA 101 North First Avenue - Suite 2340 Phoenix, Arizona 85003 602.528.3966

TIMOTHY T. and BARBARA J. CERNY,

Appellants,

vs.

ARIZONA DEPARTMENT OF REVENUE,

Appellee.

Docket No. 1860-01-I

NOTICE OF DECISION:
FINDINGS OF FACT AND
CONCLUSIONS OF LAW

The State Board of Tax Appeals, having considered all evidence and arguments presented, and having taken the matter under advisement, finds and concludes as follows:

FINDINGS OF FACT

Timothy T. and Barbara J. Cerny ("Appellants") were residents of Alaska during all years pertinent to this matter. Beginning in 1992, Appellants invested in Arizona real estate through Denali National Trust, Inc. ("Denali"), an Alaska S corporation. The investments resulted in large losses in most of the years until 1998 when much of the real estate was sold at a substantial gain. Appellants included the yearly losses in their federal adjusted gross income for tax years 1993 through 1997.

Neither Appellants nor Denali filed any Arizona returns until 1998. In 1998, Appellants filed an Arizona nonresident personal income tax return (140NR) reporting Arizona income from the sale of their investments. Thereafter, Appellants filed an amended return for 1998 carrying forward net operating losses ("NOLs") from the years 1993 through 1997 when Appellants did not file Arizona returns and claiming a refund. Appellants did not include the NOLs on their 1998 federal return because they had been reported on federal returns in prior years.

The Arizona Department of Revenue (the "Department") denied Appellants claim for refund. After unsuccessfully protesting the refund denial to the Department, Appellants now timely appeal to this Board.

DISCUSSION

The issue before the Board is whether Appellants are entitled to the refund claimed.

Appellants claim for refund is posited on the equitable ground that they received no tax benefit in Arizona from \$1,185,386 of Denali losses during 1993 through 1997 and, thus, should be allowed to reduce their gain by that amount. The Department rejects the idea that Arizona law provides any basis for an individual net operating loss deduction separate and apart from a NOL that might be reflected in federal adjusted gross income, and it denies that there is any general tax benefit rule that might produce the equitable result the taxpayers seek. The Department is correct as to both positions. However, this is not dispositive of this appeal.

A threshold tax question before the Board under A.R.S. § 43-1091 when dealing with a nonresident is to determine the portion of federal adjusted gross income that represents income from Arizona. This, in turn, in the case of nonresident shareholders of S corporations, requires a determination of the Arizona income of the corporation under A.R.S. § 43-1126. Under A.R.S. § 43-1122(8), the Arizona taxable income of a corporation shall be determined after subtracting from Arizona gross income "[t]he amount of net operating loss allowed by A.R.S. § 43-1123.

A.R.S. § 43-1123(A) defines two types of NOLs.¹ A.R.S. § 43-1123(A)(1) deals with corporations which have NOLs for the current tax year "within the meaning of section 172(c) of the internal revenue code." A.R.S. § 43-1123(A)(2) provides that, for all other corporations, "net operating loss" means the

¹ A.R.S. § 43-1126(A) provides that if a corporation is an S corporation under federal tax law, it will be treated as an S corporation for Arizona tax purposes. A.R.S. § 43-1101(7) provides that for purposes of Chapter 11, "'Person' and 'taxpayer' means a corporation." S corporations are not excluded from this definition. Thus, the Board must conclude that A.R.S. § 43-1123 encompasses S corporations as well as all other corporations.

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"excess of the subtractions specified in section 43-1122 over the sum of the Arizona gross income plus the additions specified in section 43-1121."

Among the subtractions specified for computing a corporation's Arizona taxable income is "the amount of income from a domestic international sales corporation [DISC] required to be included in the income of its shareholders" under the Internal Revenue Code ("IRC"). A.R.S. § 43-1122(15). There is no mention of any adjustment for the amount of income (or loss) from an S corporation required to be included in the income of its shareholders under the IRC, which is certainly a much more common situation than a DISC and one of which the legislature can be presumed to be aware.

Under the doctrine of *inclusio unis est exclusio alterius*, the specific inclusion of *one* type of corporation that has its income taxed to its shareholders should be interpreted to absolutely exclude *any other corporation* which has its income taxed to its shareholders. Thus, the Board concludes that for purposes of calculating an S corporation's NOL, there is no adjustment to the amount available to the corporation for the amounts passed through to the shareholders. The result is that Denali had NOL carryovers to 1998 for the five preceding years. *See* A.R.S. § 43-1123(B). It is undisputed that the portion of those losses attributable to the taxpayers amounted to \$1,185,386.

It may be argued that the legislature could not have intended such a result. However, the statute seems clearly to provide the S corporation with a five-year Arizona net operating loss carryforward. Where a statute is clear and not ambiguous, it is not the Board's role to attempt to ascertain the legislative intent. That the interaction of the S corporation and its shareholders even under the federal internal revenue code is not always clear or intuitive is well-known to any tax practitioner. See, e.g., Gitlitz v. Commissioner, 531 U.S. 206 (2002). Gitlitz involved the interplay of S corporation and cancellation of indebtedness rules. The Internal Revenue Service argued unsuccessfully that Congress could not possibly have intended what the literal language of the tax statutes was ultimately held by the Supreme Court to permit. The last paragraph of the Court's opinion is instructive in this regard.

"Courts have discussed the policy concern that, if shareholders were permitted to pass through the discharge of indebtedness, before

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reducing any tax attributes, the shareholders would wrongly experience a 'double windfall': They would be exempted from paying taxes on the full amount of the discharge of indebtedness, and they would be able to increase basis and deduct their previously suspended losses. See, e.g., 182 F.3d at 1147-1148. Because the Code's plain text permits the taxpayers here to receive those benefits, we need not address this policy concern.

There is no tax windfall for Appellants in the instant situation. If Appellants had had Arizona taxable income between 1993 and 1997 that had been offset by the losses, the Board would hold against Appellants on the ground that they were equitably estopped from obtaining a second tax benefit for the same deductions. However, that is not the situation before the Board. Appellants had no Arizona gross income, only the Denali losses. The corporation had an NOL deduction available to it in 1998, of which Appellants' share as stockholders in the S corporation was \$1,185,386. Under IRC § 1366(a), items of income, expense, and loss all pass through from the corporation to the shareholders. These would, thus, reduce the Arizona gross income on Appellants' Form 140NR for 1998. Therefore, the Board holds that \$1,185,386 is available to Appellants as a reduction in calculating the income they derived from the Denali S corporation for Arizona income tax purposes, and that Appellants are entitled to a refund of the Arizona tax paid on that amount.

CONCLUSIONS OF LAW

Appellants are entitled to the refund claimed. See A.R.S. § 43-1123.

<u>ORDER</u>

THEREFORE, IT IS HEREBY ORDERED that the appeal is granted, and the final order of the Department is vacated.

This decision becomes final upon the expiration of thirty (30) days from receipt by the taxpayer, unless either the State or taxpayer brings an action in superior court as provided in A.R.S. § 42-1254.

DATED this 22nd day of April , 2002.

STATE BOARD OF TAX APPEALS

anice C. Washington, Chairperson

		Notice of Decision Docket No. 1860-01-I
	1	WLR:alw
	2	CERTIFIED
	3	Copies of the foregoing Mailed or delivered to:
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