Strange v. Commissioner, 114 T. C. 206 (2000)

State nonresident income taxes paid on net royalty income are not deductible in computing adjusted gross income.

Summary

Charles and Sherrie Strange sought to deduct state nonresident income taxes paid on net royalty income from their interests in oil and gas wells when calculating their federal adjusted gross income. The Tax Court ruled against them, holding that such state taxes are not deductible under IRC sections 62(a)(4) and 164(a)(3) for computing adjusted gross income. The court reasoned that these taxes were not directly attributable to the property producing the royalties but were imposed on the income itself, following precedent established in Tanner v. Commissioner.

Facts

Charles and Sherrie Strange owned interests in oil and gas wells across nine states and received royalties from these properties. They paid state nonresident income taxes on their net royalty income and reported the royalties on Schedule E of their federal tax returns. The Stranges deducted these state taxes in calculating their total net royalty income and thus their adjusted gross income for the years in question. They elected to take the standard deduction for their federal taxable income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Stranges' federal income taxes for the years 1993, 1994, and 1995, based on the disallowance of the state nonresident income tax deductions. The case was submitted to the U. S. Tax Court fully stipulated, with the sole issue being the deductibility of state nonresident income taxes in computing adjusted gross income.

Issue(s)

1. Whether state nonresident income taxes paid on net royalty income are deductible under IRC section 62(a)(4) in computing adjusted gross income.
2. Whether state nonresident income taxes are deductible as a trade or business expense under IRC section 62(a)(1).

Holding

1. No, because state nonresident income taxes are not attributable to property held for the production of royalties, as required by IRC section 62(a)(4).
2. No, because state nonresident income taxes are not an expense directly incurred in the production of royalties and thus not deductible under IRC section 62(a)(1).

Court's Reasoning

The court analyzed the legislative history of the relevant IRC sections and found that state income taxes are not deductible in computing adjusted gross income. The court emphasized that IRC section 62(a)(4) allows deductions only for expenses directly attributable to property held for the production of royalties, which state income taxes are not. The court cited the legislative history of the 1939 and 1954 Codes, which clarified that state taxes on net income are not deductible for adjusted gross income. The court also followed the precedent set in Tanner v. Commissioner, which held that state income taxes on net business income are not deductible. The court rejected the Stranges' argument that the addition of IRC section 164(a)(3) changed the law regarding the deductibility of state income taxes, stating that it did not alter the existing rule. The court concluded that the state nonresident income taxes were imposed on the Stranges' net royalty income and not on the property itself, thus not qualifying for a deduction under IRC section 62(a)(4).

Practical Implications

This decision clarifies that state nonresident income taxes on net royalty income cannot be deducted in computing federal adjusted gross income. Taxpayers with income from royalties or similar sources must be aware that such taxes are not directly attributable to the property producing the income and thus are not deductible under IRC section 62(a)(4). Legal practitioners advising clients on tax matters should note that state income taxes, even when related to income from a business or property, are not deductible for adjusted gross income purposes. This ruling reaffirms the principle established in Tanner v. Commissioner and may impact how taxpayers structure their income and deductions. Taxpayers should consider itemizing deductions if they pay significant state income taxes, as these may be deductible from adjusted gross income under IRC section 164(a)(3).

