

WILBUR & NELL MASSEY
6561 Huntcliff West
Mobile, AL 36608,

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers,

DOCKET NO. INC. 97-335

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

FINAL ORDER

Wilbur and Nell Massey ("Taxpayers") filed an amended 1995 Alabama income tax return and claimed a refund of \$210. The refund was based on a loss incurred by an irrevocable trust that the Taxpayers, as beneficiaries of the trust, passed through to their individual return. The Department denied the refund, and the Taxpayers appealed pursuant to Code of Ala. 1975, 40-2A-7(c)(5)a. A hearing was conducted on October 2, 1997. CPA Charles C. Feagin, Jr. represented the Taxpayers. Assistant Counsel Duncan Crow represented the Department.

The issue in this case is whether a loss incurred by an irrevocable trust can be passed through to the beneficiaries of the trust to offset trust income. That issue was previously addressed by the Administrative Law Division in Michael D. & Netagene Thompson v. State of Alabama, Docket INC. 92-128 (Admin. Law Div. 01/03/94). The relevant portion of that Final Order is set out below:

Michael D. Thompson, as beneficiary of the trust, subsequently deducted the loss on his individual 1990 Alabama return. The Department disallowed the pass-through deduction and entered the assessment in dispute.

Under federal law, the unused portion of a trust loss is allowed as a deduction to the succeeding trust beneficiaries. 26 U.S.C. 642(h). The Taxpayers concede that Alabama has no statute corresponding to IRC

642(h). Nonetheless, the Taxpayers argue that the pass-through should be allowed based on Department Reg. 810-3-25-.05(7)(a). That regulation reads as follows:

(a) A loss on the final return of a revocable trust is allowed to pass on to the grantor unless the trust is irrevocable as to income, then the loss is allowed to pass on to the beneficiary.

The last part of subparagraph (a) does indicate that a loss from an irrevocable trust can be passed through to the succeeding beneficiary.

The Department argues that the last part of subparagraph (a) is wrong and has no basis in the law. Rather, the Department contends that subparagraph (b) of Reg. 810-3-25-.05(7) is controlling. Subparagraph (b) reads as follows:

(b) A loss on an irrevocable trust cannot be passed on to the grantor or the beneficiary.

The function of a declaratory regulation is to interpret a statute. A regulation cannot limit or deny a deduction that is otherwise allowed by statute. Boswell v. Bonham, 247 So.2d 379. By the same logic, a regulation cannot create or allow a deduction that is not already authorized by statute.

Deductions are allowed only as a matter of legislative grace, and can be granted only where clearly allowed by statute. State v. Sprinkle Net Shop, Inc., 351 So.2d 608. The Taxpayers concede that Alabama does not have a statute allowing a pass-through of a irrevocable trust loss to a beneficiary. Consequently, notwithstanding subparagraph (a) of Reg. 810-3-25--.05(7), the claimed pass-through deduction in issue was properly disallowed.

The same rationale in Thompson controls in this case. Because Alabama has no statutory counterpart to 26 U.S.C. 642(b), the pass-through deduction claimed by the Taxpayers cannot be allowed. To prevent further confusion, that part of Reg. 810-3-25-.05(7)(a) that is inconsistent with subparagraph (7)(b) should be revoked.

The Department's denial of the refund in question is affirmed.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, 40-2A-9(g).

Entered December 9, 1997.

BILL THOMPSON
Chief Administrative Law Judge

BT:ks

cc: Duncan Crow, Esq.
Charles C. Feagin, Jr., CPA
Kim Herman (257-60-5030)