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Oregon Tax Court Finds Taxpayers Not Bound by Incorrect Federal Adjustments

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The practice of reporting federal level audit adjustments to state taxing authorities is as common as eating turkey on Thanksgiving. Often this reporting leads to state-level adjustments on previously filed returns. However, where the federal adjustments are wrong, even if agreed to by the taxpayer, should such adjustments impact a state return whose starting point is federal taxable income? The Oregon Tax Court, Magistrate Division, recently addressed this issue. *Spears v. Dep't of Revenue*, TC-MD 230445G (Or. Tax Ct. Oct. 15, 2024).

On their original 2018 federal Schedule C, the Spearses understated the gross receipts from their eBay business by $38,938. However, because the Spearses also failed to include an amount on the returns line of the Schedule C, their net profit was correctly stated. To correct the errors, the Internal Revenue Service ("IRS") proposed increasing the gross receipts to the accurate number, and the Spearses separated their gross receipts from their returns—resulting in a net tax reduced by $893. The Spearses agreed to this net tax reduction, despite that "the adjustments by which the IRS achieved it were not accurate." Specifically, to achieve the agreed upon reduction, the IRS increased the Spearses' taxable income by $51,626 (the amount of their Schedule C profit plus their self-employment tax deduction) and then eliminated their $6,813 self-employment tax.

The Oregon Department of Revenue (the "Department") adjusted the Spearses' 2018 return to conform to the changes made by the IRS—the Spearses asked the tax court to reverse the Department's adjustments.

Despite agreeing that the IRS adjustments were wrong, the Department took the position that it was prohibited under Oregon law "from making further adjustments to the Oregon return that would go against the IRS adjustments…." In support of its position, the Department relied on Oregon Revised Statute 316.048 which provides:

The entire taxable income of a resident of this state is the federal taxable income… as defined in the laws of the United States, with the modifications, additions and subtractions provided [under Oregon law].

Applying this statute, and corresponding Oregon case law, the tax court determined that the Department's arguments were "groundless" and "found no purchase in the courts." Rather, "while changes made to a federal return generally flow through to the taxpayer's Oregon return," the Department is under no obligation to apply changes where it makes a "different factual or legal determination" (internal citation omitted). Instead, the Department is charged with administering Oregon law, and must use its independent authority to "apply federal tax provisions as Oregon law." As a result of its findings, the tax court ordered the Department to reverse its adjustments in full.

Ultimately, the result in *Spears* was a victory for the taxpayers. However, its result should also serve as a reminder to taxpayers that reporting federal audit adjustments may lead to further state inquiries. Taxpayers should ensure that any federal audit adjustments they agree to are accurately calculated and are not agreed to solely for reasons of expediency.

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