

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 22399, 22400, 23012,
[Redacted])	and 23013
)	
Petitioners.)	DECISION
)	
)	

On September 11, 2009, the Idaho Tax Commission’s (Commission) Income Tax Audit Bureau (ITA) issued a Notice of Deficiency Determination (NODD) to [Redacted] (petitioner-HW) proposing additional income tax, penalty, and interest for taxable years 2006 and 2007 in the amount of \$157,123. On June 3, 2010, the ITA issued a second NODD to the petitioner-HW proposing additional income tax, penalty, and interest for taxable year 2007 in the amount of \$46,129. The total proposed additional tax, penalty, and interest is \$203,252.

On September 11, 2009, the ITA issued an NODD [Redacted] (petitioner-SC) for taxable years 2006 and 2007. On June 3, 2010, the ITA issued a second NODD to the petitioner-SC for taxable year 2007. The adjustments proposed by the ITA in the NODDs to the petitioner-SC did not result in any additional tax due since the petitioner-SC filed as an S corporation; however, the adjustments do have a tax impact to its sole shareholder.

The petitioners filed a timely protest and petition for redetermination. The petitioners were informed of their appeal rights. The Idaho Code section 63-3045(2) hearing was held on June 1, 2010, for the NODDs issued September 11, 2009, and the petitioners waived their right to an Idaho Code section 63-3045(2) hearing on the NODDs issued June 3, 2010. The petitioners requested that the Commission combine the NODDs issued June 3, 2010, with the NODDs issued September 11, 2009, when rendering its decision. The Commission, after having reviewed the file, hereby issues its decision.

A. ISSUES

1. The petitioner-SC protests the ITA's treatment of including a percentage of the cost of [Redacted] purchased in 2006 ([Redacted]) in the Idaho property numerator. The petitioner-SC argues it is entitled to include the entire cost [Redacted].

2. The petitioner-SC protests the ITA's treatment of allowing a percentage of the cost [Redacted] as "qualified property" for purposes of the Idaho investment tax credit (ITC). The petitioner-SC argues that it is entitled to include the entire cost [Redacted].

3. The petitioner-SC does not dispute that the sale in 2007 [Redacted] acquired in 2005 triggered ITC recapture.

4. The petitioner-HW protests the ITA's decrease in the amount of ITC flowing to the petitioner-HW from the petitioner-SC.

5. The petitioner-HW does not protest the recapture of ITC; however, the petitioner-HW does protest the proposed assessment of penalties relating to the ITC recapture.

B. FINDINGS

The Commission finds that the petitioner-SC is entitled to include 100 percent of its cost of the [Redacted] calculation of its Idaho property numerator and as "qualified property" for purposes of Idaho ITC. Additionally, the Commission declines to impose the penalties asserted in the NODD issued to petitioner-HW.

C. PETITIONER-SC

The petitioner-SC is the sole shareholder of a corporation that under federal law is treated as a qualified Subchapter S corporation (QSSS). The QSSS purchased [Redacted]. Under federal law, a QSSS is disregarded and the assets and liabilities of the QSSS are simply treated as if the S Corporation parent owned the assets and liabilities. [Redacted].

The petitioner-SC filed its Idaho Form 41S Idaho S Corporation Income Tax Return for taxable years 2006 and 2007, on October 15, 2007, and September 15, 2008, respectively. In these filings, the petitioner-SC, when calculating its Idaho property factor percentage (one of three factors used to determine the Idaho apportionment percentage) included in the property factor numerator and denominator 100 percent of its cost [Redacted]. However, when determining the amount of “qualified property” for purposes of the ITC, the petitioner-SC only included \$2,977,193 of its \$7,079,100 cost [Redacted] based upon the following formula:

	Idaho	Divided	Total			
[Redacted]Cost	Times	Departures	By	Departures	Equals	Amount
[Redacted] \$7,079,100	x	45	÷	107	=	\$2,977,193

On October 15, 2007, the petitioner-SC filed an amended Idaho Form 41S and claimed the entire \$7,079,100 as qualified property eligible for the ITC.

In addition to the purchase [Redacted], the petitioner-SC had additional qualifying property of \$230,791 for a total amount of qualifying property of \$7,309,891. When multiplied by 3 percent, the amount of Idaho ITC that passes through from petitioner-SC to petitioner-HW is \$219,297.

The ITA audited the petitioner-SC’s 2006 (original and amended) income tax return and its 2007 income tax return and disagreed with the petitioner-SC’s inclusion [Redacted] at 100 percent of cost in the petitioner-SC’s Idaho property factor numerator and as qualified property for purposes of the ITC calculation.

The ITA obtained the [Redacted] log. The [Redacted] log, for the period July 1, 2006, through December 31, 2006, reflects that approximately 38 percent (35/93) [Redacted] were within Idaho as follows:

| | [Redacted] |
|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| [Redacted] |
| [Redacted] |
| [Redacted] |
| [Redacted] |
| [Redacted] |
| [Redacted] |
| [Redacted] |

The amount [Redacted] cost to be included in the petitioner-SC's 2006 and 2007 Idaho property numerator was determined by the ITA as follows:

			Idaho		
[Redacted]	[Redacted]Cost	Times	Departures	Equals	Amount
[Redacted]	\$7,079,100	x	38%	=	\$2,690,058

As authority for its position, the ITA cites Idaho Income Tax Administrative Rule 475.03 which requires the use of Idaho departures over total departures when determining that portion [Redacted] to be included in the property factor.

Based upon the same formula above, the ITA disallowed all but \$2,690,058 of the \$7,079,100 cost [Redacted] as qualifying for the ITC. As authority for its position, the ITA cites Idaho Income Tax Administrative Rule 714.02.a. which requires the use of Idaho departures over total departures when determining that portion [Redacted], used within and without Idaho, to be included in the ITC calculation **or** the Idaho Income Tax Administrative Rule 714.02.b. requirement that the cost of the airplane be the same amount as included in the Idaho property numerator; which, as previously discussed, under ITA's interpretation, the petitioner-SC would

still be required to use Idaho departures over total departures.

The petitioner-SC argued in its letter dated November 12, 2009, in part:

. . . treats all revenue, payroll and property factors associated with their aircraft operations as Idaho sourced. This treatment is based on the fact that the operations are controlled from and centered in Idaho, the majority of the costs associated with the operations are incurred in Idaho, and the airplane is domiciled in Idaho, with all roundtrip flights departing from and returning to Idaho. When the aircraft is leased by a third party, the destination of the aircraft is ancillary to its business purpose. The owner has no control over its destination and no visibility to purpose of the trip. Rather, from the aircraft owner's perspective, the critical factor is the location of the property at the time it is leased and that it returns to that location when the leasing period is ended. The actual use of the aircraft is not related to the primary operations of the Company [the petitioner-SC]. As such, there is no business connection established with the destination state when the plane is leased and it would not be appropriate to attribute any of the leasing activity to any state other than Idaho. Attributing all business activity related to the aircraft to Idaho reflects the economic realities of the use of the aircraft.

The [Redacted] is at times leased through an independent [Redacted] company as part of its pool [Redacted] available [Redacted] or leased by the officers of the petitioner-SC for personal use. The petitioner-SC is compensated for both types of lease arrangements.

D. PETITIONER-HW

The petitioner-HW is comprised of a husband and wife, both of which are Idaho residents, for taxable years 2006 and 2007, filed an Idaho Form 40 Individual Income Tax Return on a filing joint basis. The husband is the sole shareholder of the petitioner-SC.

For taxable year 2006, the petitioner-SC passed the \$219,297 of ITC through to the petitioner-HW; however, the petitioner-HW, due to certain limitations, was unable to claim most of the \$219,297 on their Idaho Form 40 Individual Income Tax Return for taxable year 2006 and instead carried the majority of the ITC into taxable year 2007 and claimed it against their taxable year 2007 income tax liability. The ITA audited the petitioner-HW's individual income tax returns for taxable years 2006 and 2007. As a result of the ITA's audit, the ITA disallowed

\$131,672 of the ITC claimed on the petitioner-HW's 2007 individual income tax return. The ITA issued a second NODD in June 2010 to both petitioner-HW and petitioner-SC which resulted in additional tax due by the petitioner-HW relating to the recapture of ITC on the sale of the 2002 airplane in 2007.

LAW AND ANALYSIS

For a multistate corporation transacting business within Idaho, the allocation and apportionment provisions are found in Idaho Code section 63-3027.¹ The Idaho apportionment percentage is governed by Idaho Code sections 63-3027(i) through (q). Idaho Code sections 63-3027(k) through (m) govern the calculation of the Idaho property factor percentage, which is the factor at issue in this docket. These sections state:

(k) The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

(l) Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight (8) times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

(m) The average value of property shall be determined by averaging the values at the beginning and ending of the tax period, but the state tax commission may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

Idaho Income Tax Administrative Rule 475.03.c. specifically states that “The value [Redacted] used within and without Idaho during the taxable year shall be determined by multiplying the value [Redacted] by the ratio [Redacted] from locations in Idaho to total [Redacted].” Therefore, unless otherwise allowed by another statute or administrative rule, the

¹ References to Idaho Code or Rules refer to the Idaho Code or Income Tax Administrative Rules in effect for taxable year 2007 unless otherwise stated.

petitioner-SC is required to include the cost [Redacted] based upon Idaho [Redacted] to total [Redacted].² However, Idaho Code section 63-3027(s) states:

(s) If the allocation and apportionment provisions of this section do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state tax commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) Separate accounting, provided that only that portion of general expenses clearly identifiable with Idaho business operations shall be allowed as a deduction;
- (2) The exclusion of any one (1) or more of the factors;
- (3) The inclusion of one (1) or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The Commission, after review of the facts and circumstances in this docket, is satisfied that including the basis [Redacted] in the Idaho numerator based upon Idaho departures to total departures does not fairly represent the extent of the petitioner-SC's business within Idaho. Therefore, it is the Commission's finding that the petitioner-SC should include the full cost [Redacted] (\$7,079,100) in the Idaho property factor numerator when calculating the Idaho property factor percentage.

As for the amount [Redacted] that qualifies for the Idaho Code section 63-3029B Income Tax Credit For Capital Investment, subsection (10) of the Idaho statute provides the following:

(10) In the case of property used both in and outside Idaho, the taxpayer, electing to claim the credit provided in this section, must elect to compute the qualified investment in property with a situs in Idaho for all such investments first qualifying during that year in one (1), but only one (1), of the following ways:

- (a) The amount of each qualified investment in a specific asset shall be separately computed based on the percentage of the actual use of the property in Idaho by using a measure of the use, such as total miles or total machine hours, that most accurately reflects the beneficial use during the taxable year in which it is first acquired, constructed, reconstructed,

² IDAPA 35.01.01.475.03.c.

erected or placed into service; provided, that the asset is placed in service more than ninety (90) days before the end of the taxable year. In the case of assets acquired, constructed, reconstructed, erected or placed into service within ninety (90) days prior to the end of the taxable year in which the investment first qualifies, the measure of the use of that asset within Idaho for that year shall be based upon the percentage of use in Idaho during the first ninety (90) days of use of the asset;

(b) The investment in qualified property used both inside and outside Idaho during the taxable year in which it is first acquired, constructed, reconstructed, erected or placed into service shall be multiplied by the percent of the investment that would be included in the numerator of the Idaho property factor determined pursuant to section 63-3027, Idaho Code, for the same year.

Idaho Income Tax Administrative Rule 714 states, in pertinent part:³

714. IDAHO INVESTMENT TAX CREDIT -- CREDIT EARNED ON PROPERTY USED BOTH IN AND OUTSIDE IDAHO IN TAXABLE YEARS BEGINNING ON OR AFTER JANUARY 1, 1995 (RULE 714).
Section 63-3029B, Idaho Code.

01. In General. Property must be used at least part of the time in Idaho to qualify for the investment tax credit, provided it otherwise qualifies for the credit. It must also be used in Idaho in each succeeding year to which a carryover may be taken.

02. Election of Methods. The taxpayer must elect to compute the investment tax credit on property used both in and outside Idaho using either the percentage-of-use method or the amount of that property included in the Idaho property factor numerator. The credit for all property used both in and outside Idaho must be computed using the method elected.

a. If the percentage-of-use method is elected, the basis of each qualified asset is multiplied by the percentage of time, miles, or other measure that accurately reflects the use of that asset in Idaho. The use of aircraft within and without Idaho during the taxable year shall be determined by the ratio of departures from locations in Idaho to total departures. . . .

³ IDAPA 35.01.01.714.

b. If the property factor numerator option is elected, the qualified investment is the basis of the asset included in the numerator of the Idaho property factor for the year the credit is earned. . . .

(Emphasis added.)

In 2008, Idaho Income Tax Administrative Rule 714.02.b. was amended as follows:⁴

b. If the property factor numerator option is elected, the qualified investment is the basis of the asset correctly included in the numerator of the Idaho property factor for the year the credit is earned.

i. The amounts of investment tax credit computed under the percentage-of-use method and the property factor numerator option are generally the same. Differences may result when a taxpayer uses certain MTC special industry regulations that allow the taxpayer to vary from using the percentage-of-use method for determining the Idaho numerator for each item of mobile property, and instead allow another method, such as the ratio of mobile property miles in the state compared to total mobile property miles or the ratio of departures of aircraft from locations in the state compared to total departures. These special industry regulations include the regulations for airlines, railroads, and trucking companies. See Rule 580 of these rules for a list of the special industries.

ii. “Correctly included in the numerator of the Idaho property factor” means that the amount included in the Idaho property factor numerator was correctly computed using Section 63-3027, Idaho Code, and related rules including any MTC special industry regulations that apply to the taxpayer. If the amount included in the Idaho property factor numerator exceeds the amount that should have been included using Section 63-3027, Idaho Code and related rules, the investment tax credit shall be allowed only on the amount that reflects the correct calculation for purposes of computing the Idaho property factor numerator. For example, a taxpayer includes one hundred percent (100%) of the basis of an asset in the Idaho property factor numerator, but the amount correctly computed under Section 63-3027, Idaho Code, should have been fifty percent (50%) of the basis of the asset. The investment tax credit shall be allowed only on the fifty percent (50%) of the basis of the asset.

(Emphasis added.)

As discussed earlier in this decision, the Commission held that the petitioner-SC could include the entire cost [Redacted] in its Idaho property factor numerator. Accordingly, under Idaho Code section 63-3029B(10)(b), as interpreted under Idaho Income Tax Administrative

⁴ IDAPA 35.01.01.714.02.b. (2009 version).

Rule 714.02.b.ii. (2009 version),⁵ the petitioner-SC is entitled to treat the entire cost [Redacted] as “qualified property,” since the entire cost [Redacted] is the correct amount to be included in the Idaho Code section 63-3027 Idaho property factor numerator.

The final issue to be addressed is the proposed assessment of penalty on the petitioner-HW’s failure to report ITC recapture tax on the sale [Redacted] in 2007. The petitioner-HW does not dispute that the tax is owed to Idaho; however, the petitioner-HW argues that there is sufficient reasonable cause for the Commission to provide the petitioner-HW with relief from the imposition of the 10 percent Idaho Code section 63-3046(d)(1) penalty and the 5 percent Idaho code section 63-3046(a) penalty. The Commission agrees and declines to assert either of the two proposed penalties.

WHEREFORE, the Notices of Deficiency Determination dated September 11, 2009, and June 6, 2010, issued to the petitioner-SC are hereby MODIFIED, APPROVED, AFFIRMED, and MADE FINAL.

WHEREFORE, the Notices of Deficiency Determination dated September 11, 2009, and June 6, 2010, issued to the petitioner-HW are hereby MODIFIED, APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioner-HW pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$36,000	\$5,737	\$41,737
2006	-	-	-
		TOTAL DUE	<u>\$41,737</u>

Interest is calculated through December 15, 2010, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

⁵ IDAPA 35.01.01.714.02.b.ii.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' rights to appeal this decision is enclosed.

DATED this ____ day of _____ 2010.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2010, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

Receipt No.
