

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 24827
[Redacted],)	
)	
Petitioners.)	DECISION
_____)	

BACKGROUND

On September 22, 2011, the Audit Bureau (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted](Petitioners), for the taxable year 2008 assessing tax, penalty, and interest totaling \$44,317.

The Petitioners, domiciled in [Redacted], owned a share in [Redacted], a limited liability company, electing to be treated as a partnership for [Redacted] income tax purposes. [Redacted] owned another LLC, [Redacted] ([Redacted]). [Redacted] operated a [Redacted] service company doing business in Idaho and several other states. The only factor elements that the Petitioner had in Idaho were those attributed from their ownership of [Redacted] in the proportion of [Redacted] income distribution percentage of [Redacted], as required by Idaho Income Tax Administrative Rule 620.04.b and Idaho Code section 63-3027. The Petitioners had no direct property, payroll, or sales or Idaho source income that would otherwise give them an Idaho factor.

[Redacted]REMAINING ISSUES

1. Whether Idaho Code section 63-3026A(3)(a)(vii) treats a non-resident member of an LLC that has gain from the sale of another Idaho LLC, as though the member directly made the sale themselves. The “Secondary Position” referred to in the NODD.
2. Whether the Petitioners are entitled to the Idaho Capital Gains Deduction under Idaho Code section 63-3022H(3).

3. Whether the penalties under Idaho Code section 63-3046(a) should be waived in this case.

DISCUSSION

Issue 1. Whether Idaho Code section 63-3026A(3)(a)(vii) treats a non-resident member of an LLC that has gain from the sale of another Idaho LLC, as though the member directly made the sale themselves.

Attempting to treat LLC members as though they directly made the sale actually made by the LLC would be in conflict with a couple of existing Tax Administrative Rules; Rule 263 and Rule 280.

263 IDAHO SOURCE INCOME OF NONRESIDENT AND PART-YEAR RESIDENT INDIVIDUALS -- DISTRIBUTIVE SHARE OF S CORPORATION AND PARTNERSHIP INCOME (RULE 263).

Section 63-3026A(3), Idaho Code.

01. In General. The taxable amount of a shareholder's pro rata share or a partner's distributive share of business income, gains, losses, and other pass-through items from an S corporation or partnership operating both within and without Idaho is determined by multiplying each pass-through item by the Idaho apportionment factor of the business. The Idaho apportionment factor is determined pursuant to Section 63-3027, Idaho Code, and related rules. (3-20-97)

02. Nonbusiness Income. Pass-through items of identifiable nonbusiness income, gains, or losses of an S corporation or partnership constitute Idaho source income to the shareholder or partner if allocable to Idaho pursuant to the principles set forth in Section 63-3027, Idaho Code. (3-20-97)

03. Pass-Through Items. Whether a pass-through item of income or loss is business or nonbusiness income is determined at the pass-through entity level. Pass-through items of business income or loss may include: (3-20-97)

a. Ordinary income or loss from trade or business activities; (3-20-97)

b. Net income or loss from rental real estate activities; (3-20-97)

c. Net income or loss from other rental activities; (3-20-97)

d. Interest income; (3-20-97)

e. Dividends; (3-20-97)

f. Royalties; (3-20-97)

g. Capital gain or loss; (3-20-97)

h. Other portfolio income or loss; (3-20-97)

i. Gain or loss recognized pursuant to Section 1231, Internal Revenue Code.
Underline added.

Idaho Income Tax Administrative Rule 280 **PARTNERSHIPS OPERATING WITHIN AND WITHOUT IDAHO (RULE 280)**. Sections 63-3027 and 63-3030(a)(9), Idaho Code.

01. In General. A partnership that operates within and without Idaho must apply the principles of allocation and apportionment of income set forth in Section 63-3027, Idaho Code, and related rules to determine the extent of partnership income that is derived from or related to Idaho sources. The use of a combined report, however, is available only to C corporations. (4-5-00)

02. Exceptions to Apportionment Formula. If the method described in Subsection 280.01 does not fairly represent the extent of the business activity in Idaho, the partnership may file a request to use, or the Tax Commission may require, an alternative method, including the following: (3-30-07)

- a. Separate accounting as provided in Rule 585 of these rules; (3-30-07)
- b. The exclusion of a factor pursuant to Rule 590 of these rules; (3-30-07)
- c. An additional factor or substitute factor pursuant to Rule 595 of these rules; or (3-30-07)
- d. The employment of any other method that would fairly represent the extent of business activity in Idaho. (3-30-07)

03. Information Provided to Partners. The partnership must provide to each partner information necessary for the partner to compute his Idaho income tax. Such information must include: (4-5-00)

- a. The partner's share of each pass-through item of income and deduction; (4-7-11)
- b. The partner's share of each Idaho addition and subtraction; (4-7-11)
- c. The partner's share of Idaho qualifying contributions, Idaho tax credits, and tax credit recapture; (4-7-11)
- d. The partner's share of income allocated to Idaho; (4-7-11)
- e. The partnership's apportionment factor, and if the partner is not an individual, the partnership's property, payroll and sales factor numerator and denominator amounts, including the amount of capitalized rent expense; and (4-7-11)
- f. The partner's distributive share of partnership gross income if the partner is an individual, trust, or estate.

Applying Idaho Income Tax Administrative Rule 263, we have determined that the Petitioners have no Idaho source income. Rule 280 describes the exceptions to apportionment formula in situations that do not fairly represent the extent of the business activity in Idaho.

[Redacted]Idaho Income Tax Administrative Rule 620.04. says in relevant part:

Partnership Income as Business Income of the Partner. (3-20-97)

- a. Income.** If the income or loss of a partnership is business income or loss to a corporate partner, its share of this net business income or loss shall be apportioned together with all other net business income or loss of the corporation. Business

income or loss is defined by Section 63-3027(a)(1), Idaho Code, and Rules 330 through 336 of these rules. (4-11-06)

b. Factors. A corporate partner's share of the partnership property, payroll, and sales after intercompany eliminations, shall be included in the numerators and the denominators of the partner's property, payroll, and sales factors when computing its apportionment formula. The partner's share of the partnership's property, payroll, and sales is determined by attributing the partnership's property, payroll, and sales to the partner in the same proportion as its distributive share of partnership income if reporting net income for the taxable year or in the same proportion as its distributive share of partnership losses if reporting a net loss for the taxable year. Generally, the partnership's property, payroll, and sales includable in the corporation's factor computations is determined in accordance with Section 63-3027, Idaho Code, and related rules. To determine how the sales attribution rules of Section 63-3027(q), Idaho Code, apply to the sales factor of the corporate partner, the sales of the partnership are treated as if they were sales of the corporation. (Emphasis added)

Under the standard apportionment formula, the sale of [Redacted] was not apportionable income in 2007 because the sale had not closed yet, therefore not included in [Redacted] taxable income. In 2008, [Redacted] gain on the sale of [Redacted] is apportionable income and taxable for federal tax purposes, however [Redacted] and therefore the Petitioner had a zero Idaho factor as a result of the [Redacted] agreement modification distributing all of the income or losses to the purchaser of [Redacted].

Treasury Regulation 1.704-(b) Partner's distributive share allows partners in a partnership to agree to distribute income and loss using a method other than the ownership percentage as long as there is a "substantial economic effect" present. The Petitioner's position is that [Redacted] was valued at December 31, 2007, and that valuation established the purchase price. The purchaser bought the benefits of ownership of the on-going enterprise at the end of 2007 and is entitled to the income (or to suffer any losses) from then on. Those facts establish that there was "substantial economic effect" and therefore the change in the distribution percentages is acceptable.

[Redacted]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 application of Idaho Code section 63-3027(s) was the central issue in Union Pacific Corp. v Idaho State Tax Commission case Idaho Supreme Court.¹ The court stated:

That the Tax Commission may require alternative apportionment

- (a) if the allocation and apportionment provisions of the statute do not fairly represent the extent of the taxpayer's business and
- (b) if the alternative apportionment is reasonable.
- (c) Gross distortion of multistate taxpayer's income attributable to state is not requirement for alternative apportionment.

The court also said the party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate.²

Audit failed to show that alternative apportionment was appropriate in the NODD to Holding. Therefore, Docket Number 24821 was cancelled by the Commission. That removed the factor calculated by Audit and passed through in the current NODD.

In the NODD at hand, Audit asserted a "Secondary Position" stating that even if Holding has a zero factor, that the members have to use the prior year's factor based on Idaho Code section 63-3026A(3)(a)(vii).

¹ Union Pacific Corp. v Idaho State Tax Commission, 139 Idaho 572, 83 P.3d 116 (2004).

² *Id.* at 575 (citations omitted).

Idaho Code section 63-3026A Computing Idaho taxable income of part-year or nonresident individuals, trusts and estates.

Section (3)(a)(vii) says in relevant part: Gains or losses realized from the sale or other disposition of a partnership interest or stock in an S corporation to the extent of the partnership's or S corporation's Idaho apportionment factor in the taxable year immediately preceding the year of sale...

The Petitioner argues in their protest that section 63-3026A is limited by its explicit terms to gains or losses incurred by a part-year or nonresident, individual, trust or estate. There were no individuals, estates, or trusts that were members in [Redacted]. The gain on the sale belonged to [Redacted].

In Futura v the Idaho State Tax Commission³, the Idaho Supreme Court said.

“Whatever ambiguity exists under taxation statute must be resolved in favor of taxpayer.”

Idaho Code section 63-3027(r) says in relevant part:

Sales, other than sales of tangible property, are in this state, if:

- (1) The income-producing activity is performed in this state; or
- (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

In the present case, the [Redacted] that the Petitioners were members of, had sold the business, and transferred the control, management and most importantly all the income or losses derived from that business as of December 31, 2007. During 2008, the only business was the sale of the intangible membership interest [Redacted] had in [Redacted]. Under 63-3027(r) that sale was sourced to Washington, the domicile state of [Redacted]. The zero Idaho apportionment factor was passed through to the nonresident members, including the Petitioner in this matter.

Asserting that 63-3026A(3)(a)(vii) applies to the members as though they were the direct

³ Futura v Idaho State Tax Commission, 92 Idaho 288, 442 P.2d 174

members in [Redacted] would ignore the existence of [Redacted] and be a deviation from the standard apportionment formula.

Audit cites Internal Revenue Code Section 702(b) as support for attributing the Idaho source to the gain as it passes to the members.

702(b) Character of items constituting distributive share. The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

The Internal Revenue Code is silent when it comes to matters of apportioning income for state income tax purposes. To infer that the "Character" of the gain on the sale of [Redacted] by [Redacted], includes sourcing the gain to the Idaho sales factor and that the sourcing stays intact when passed to nonresident members, is adding a characteristic that does not otherwise exist.

The Idaho Supreme Court has established a threshold to use when asserting an alternative apportionment formula⁴.

The alternative formula for computing taxable income of a multistate or unitary corporation is the exception, and the party that wants to use an alternative formula has the burden of showing that the alternative is appropriate; the mere fact that the use of an alternative form of computation produces a higher business activity attributable to the state is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.

In that same case the Idaho Supreme Court has established some standards that must be met.

Reasonableness of alternative apportionment formula has been defined as being made up of three elements: (1) the division of income fairly represents business activity and, if applied uniformly, would result in taxation of no more or no less than 100 percent of the taxpayer's income; (2) the division of income does not create or foster lack of uniformity among Uniform Division of Income for Tax Purposes Act (UDITPA) jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in the taxing state.

If [Redacted] had any direct property, sales, or payroll in Idaho during 2008, that would

⁴ Union Pacific Corporation v Idaho State Tax Commission, 139 Idaho 572, 83 P.3d 116

create different factors for the ordinary business income and the gain.

The NODD in the present case failed to show that the use of an alternative apportionment method would more fairly represent the Petitioners business activity in Idaho. The lack of justification for the use of an alternative apportionment not only fails the burden of showing that it is appropriate, it also violates 63-3045(1)(a) standard of providing a specific explanation of the changes.

Issue 2. Idaho Code section 63-3022H(3) is narrowly written.

Property held by an estate, trust, S corporation, partnership, Limited Liability Company or an individual is "qualified property" under this section if the property had an Idaho situs at the time of sale and is:

- (a) Real property held at least twelve (12) months;
- (b) Tangible personal property used in Idaho for at least twelve (12) months by a revenue-producing enterprise;
- (c) Cattle or horses held for breeding, draft, dairy or sporting purposes for at least twenty-four (24) months if more than one-half (1/2) of the taxpayer's gross income (as defined in section 61(a) of the Internal Revenue Code) for the taxable year is from farming or ranching operations in Idaho;
- (d) Breeding livestock other than cattle or horses held at least twelve (12) months if more than one-half (1/2) of the taxpayer's gross income (as defined in section 61(a) of the Internal Revenue Code) for the taxable year is from farming or ranching operations in Idaho;
- (e) Timber grown in Idaho and held at least twenty-four (24) months;
- (f) In determining the period for which property subject to this section has been held by a taxpayer, the provisions of section 1223 of the Internal Revenue Code shall apply, except that the holding period shall not include the holding period of property given up in an exchange, when such property would not have constituted qualified property under this section without regard to meeting the holding period nor shall the holding period include any time period in which the property subject to this section was held by a corporation other than an S corporation.

Idaho Income Tax Administrative Rule 171.02. explains that the sale of intangible property like a membership in an LLC, is not eligible for the capital gains deduction. Calculations below:

[Redacted]

Summary of Adjustments

		2008	
		Total	Idaho
1.	Adjusted Gross Income per Return	\$686,395	\$326,226
2.	Audit Adjustments		
a.	Idaho Capital Gains Deduction	885,580	
b.	[Redacted]		0
3.	Adjusted Income Corrected	<u>1,571,975</u>	<u>326,226</u>
4. a.	Itemized Deductions	58,359	
b.	State Income Taxes	42,435	
c.	Net Itemized Deductions	15,924	
d.	Standard Deduction	10,900	
e.	Larger of Itemized Deductions or Standard Deduction	15,924	
f.	Personal Exemptions	11,665	
g.	Net Standard & Personal Deductions	<u>27,589</u>	
5.	Idaho Adjusted Income	326,226	326,226
6.	Total Adjusted Income	1,571,975	
7.	Divide Line 5 by Line 6 equals: Idaho Percentage	20.75%	
8.	Multiply Line 4g by Line 7 equals: Idaho Percentage of Personal Deductions		<u>5,725</u>
9.	Line 5 less Line 8 equals: Net Idaho Taxable Income		320,501
10.	Taxable Income per Return		<u>313,113</u>
11.	Line 9 less Line 10 equals: Adjustment carried to Schedule 042 line 2a.		<u><u>\$7,388</u></u>

Form 042 Modified 1-29-13	
1. IDAHO TAXABLE INCOME per return or as previously adjusted	313,113
2. Adjustments	
a. Summary of Adjustments	7,388
3. IDAHO TAXABLE INCOME REVISED	320,501
4. Corrected Income Tax Liability	24,357
5. Income Tax Liability, before credits per return or as previously adjusted	23,779
6. Grocery Credit	
9. ADDITIONAL TAX or (REFUND)	578
10. Sales/Use Tax	
11. Permanent Building Fund Tax	
12. Idaho Withholding	
14. NET ADDITIONAL TAX (REFUND)	578
15. Penalties	29
16. Interest to 4/18/2013	101
17. TOTAL DEFICIENCY OR (REFUND)	708

Issue 3. Whether the penalties under Idaho Code section 63-3046(a) should be waived in this case.

The penalties related to the 2008 income from the gain passed through [Redacted] and sourced to Idaho have been waived. However, the Commission finds the penalties assessed on the denial of the Idaho Capital Gain deduction appropriate in this case.

CONCLUSION

The Notice of Deficiency Determination dated September 22, 2011, and directed to the Petitioners is hereby Modified and Upheld by this decision.

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/08	\$578	\$29	\$101	\$708
			TOTAL DUE	<u>\$708</u>

Interest is calculated through April 18, 2013, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

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

An explanation of the Petitioners' right to appeal this decision is enclosed.

DATED this _____ day of _____ 2013.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2013, 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.
