

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 25557
[Redacted],)	
)	
Petitioner.)	DECISION
_____)	

A Notice of Deficiency Determination (NODD) was issued to [Redacted] (petitioner) seeking additional income tax and interest in the amount of \$3,259, concerning taxable years ending June 30, 2009, June 30, 2010, and June 30, 2011. An income tax auditor (auditor) from the Idaho State Tax Commission’s (Commission) Audit Division (ITA) issued the NODD.

The petitioner filed a timely petition for redetermination (petition). Based on the information submitted by the petitioner and a review of the ITA’s file, the Commission now issues this decision.

The only issue presented in this docket is the calculation of the amount of income tax the petitioner is required to pay as a result of its shareholders’ election to have the petitioner pay their Idaho income tax.

The petitioner is a corporation that was incorporated outside of Idaho, elected to be treated as an S corporation under federal law, and was transacting business within and without Idaho. The petitioner is involved in the [Redacted]; part of which is manufactured in Idaho.

A corporation that makes a [Redacted] election to be treated as an S corporation that is transacting business within Idaho is required to file an Idaho income tax return as an S corporation.¹ Except for net recognized built-in gains or excess net passive income, Idaho does not subject an S corporation to its income tax or franchise tax other than the imposition of a

¹ See section 63-3030(a)(4), Idaho Code.

\$20 minimum tax.² Basically, the S corporation is a pass-through entity that, similar to a partnership, files an information return with Idaho. However, during the taxable years at issue in this docket, certain owners of an S corporation could elect “to have Idaho tax relating to the income described in subsection (2) of this section reported and paid by the corporation, partnership, trust or estate.”³ The income “in subsection (2)” is at the heart of this dispute and is discussed in more detail later in this decision. The election is made by the simply having the shareholder’s income tax paid by the S corporation with the filing of an Idaho Form 41S.⁴ For all of the taxable years at issue, a shareholder’s election to have the petitioner pay his tax with the filing of the Idaho Form 41S, satisfies that shareholder’s Idaho filing requirement.⁵

Numerous changes were made to Idaho Code § 63-3022L (3022L) as a result of 2010, 2011, and 2012 legislation; however, those adjustments do not impact the issues under consideration in this docket.^{6,7,8}

All of the petitioner’s shareholders elected to have the petitioner pay their tax with the filing of the petitioner’s Idaho Form 41S. The petitioner’s calculation of the amount of tax paid

² See section 63-3025 or Section 63-3025A, Idaho Code.

³ See Section 63-3022L(1), Idaho Code.

⁴ See IDAPA 35.01.01.290.01. (2009 through 2011)

⁵ See IDAPA.35.01.01.801.02.

⁶ See 2010 Idaho Session Laws, ch. 37, sec. 2, p. 67 (effective January 1, 2011). Section 63-3022L(1), Idaho Code, was amended 1) to read “to have Idaho tax relating to the income described in subsection (2) of this section reported and paid by the ~~corporation, partnership, trust or estate~~ pass-through entity,” 2) to make the election an irrevocable election; 3) allow the Commission to prescribe the manner in which the elections is to be made; and 4) if no election made, require withholding. Additionally, new section 63-3006C, Idaho Code, was added providing a definition of a pass-through entity; which includes a corporation filing as an S corporation. *Id.*

⁷ See 2011 Idaho Session Laws, ch. 3, sec. 1, p. 6 (effective January 1, 2011). Basically, 1) adding language that the election is not available to a nonresident individual owner that has Idaho source income from another source, and 2) allowing the Commission to prescribe, in its rules, the deductions and credits allowed within the 3022L calculation.

⁸ See 2012 Idaho Session Laws, ch. 187, sec. 1, p. 491-92 (effective January 1, 2012). Most notably, 1) the election to have the tax paid on behalf of the shareholder was eliminated effective January 1, 2012, for taxable years beginning on or after January 1, 2012, and instead allows the pass-through entity to determine if the individual owner is included within the composite return; 2) remove the requirement that the nonresident individual owner not have any other Idaho source income; and 3) make the entity liable for the 3022L tax under certain conditions.

on behalf of its six shareholders is shown in Table 1; which can be found at the end of this decision.

The auditor reviewed the petitioner's calculation and disallowed the petitioner's research and development deduction based on the following argument:

Idaho Code section 63-3022 provides for certain additions and deduction allowed in computing Idaho taxable income. Research and development expenses are not included in this section as being an allowable deduction. Consequently, the deductions claimed for research and development expenses for each year of the audit have been denied. The expense amounts were obtained from line 9 of the federal Form 6765.

The petitioner disagreed with the auditor's position and in the petitioner's protest the following argument is made:

Idaho Code section 63-3022L, allows for the shareholders of an S-Corporation to elect to have their share of income reported as taxable income of the S-corporation. The taxable income of the shareholders would include the separately reported research and development expenses as a deduction in computing their taxable income. Under Internal Revenue Code section 59(e)(2), the research and development expenses must be separately reported to the shareholders and each shareholder then determines the deductibility on their respective income tax return. If not for the requirement to separately report the research and development expenses to shareholder, these expenses would have been deducted by the [petitioner] in computing ordinary income on Form 1120S.

Basically, the petitioner is relying on 3022L as allowing the deduction and the auditor is relying upon section 63-3022, Idaho Code as not allowing the deduction. The Commission will first address the petitioner's 3022L argument. 3022L was codified in 1996 as follows.⁹

63-3022L. Nonresident officers, directors, shareholders, partners or members of a corporation or partnership. - (1) Nonresident officers, directors, shareholders, partners or members of a corporation or partnership transacting business in Idaho may elect to have Idaho taxable income described in subsection (2) of this section reported and taxed as Idaho taxable income of the corporation or partnership. Income subject to the election in this subsection shall be taxed at the rate applicable to corporations. The election shall be made on the return of the corporation or partnership from which the income is received and on which the income is reported in Idaho taxable income. The election in this section is not

⁹ See 1996 Idaho session laws, ch. 340, sec. 1, p. 1141-42.

available to a nonresident who has Idaho taxable income in addition to income described in subsection (2) of this section.

(2) The election in subsection (1) of this section applies to:

(a) Wages, salary and other compensation paid to such nonresident officers, directors, shareholders, partners or members to the extent the compensation is Idaho taxable income of the nonresident to whom it is paid under section 63-3026A, Idaho Code; and

(b) The share of any income, loss, deduction or credit of an S corporation or partnership required to be included on such nonresident shareholder's, partner's or member's federal return except that such amount shall first be apportioned and allocated in the manner provided in section 63-3027, Idaho Code.

(c) When the total income attributable to a nonresident under paragraphs (a) and (b) of this subsection is less than the filing requirement of the nonresident under section 63-3030(3), Idaho Code, the income is not income under this subsection.

(3) If no election is made and a nonresident officer, director, shareholder, partner or member of a corporation or partnership transacting business in Idaho fails to file an Idaho individual income tax return reporting all or any part of the items described in subsection (2) of this section or fails to pay any tax due thereof, such corporation or partnership shall include such items in its Idaho taxable income and be taxed at the rate applicable to corporations.

(4) The provisions of this section shall not apply to a corporation, other than an S corporation, with less than fifty per cent (50%) of its income taxable within this state.

Section 3022L(2) has long governed the income, deductions, and credits to be included within the 3022L calculation. Since its codification in 1996, 3022L was amended in 1999, 2000, 2001, 2010, 2011, and 2012. The 1999 amendment expanded 3022L to include certain Idaho resident individuals.¹⁰ In 2000, 3022L was amended to expand the election to certain beneficiaries of a trust or estate and more importantly amended the statute to make the pass-through entity liable for remitting the tax on behalf of the owners rather than making any unreported income the income of the pass-through entity subject to tax.¹¹ The 2001 amendment

¹⁰ See 1999 Idaho session laws, ch. 60, sec. 3, p. 157.

¹¹ See 2000 Idaho session laws, ch. 38, sec. 1, p. 70-1. Section 63-3022(g), Idaho Code, was amended to remove language treating the owner's income not reported to Idaho by the owner as the income of the pass-through entity subject to Idaho taxation. *Id.* at 72. In 2011, an Idaho district court found that 3022L's post-2000 statutory language did not impose the tax on the entity; but instead, the tax collected by the pass-through entity remained the member's tax. See Travco Framing, LLC, CV-OC-2011-6685, Memorandum Decision and Order dated December 22, 2011.

simply eliminated a cross reference to section 63-3026A, Idaho Code, and a cross reference to the section 63-3027, Idaho Code, allocation and apportionment provisions.¹²

During taxable years 2008 and 2009, 3022L read as follows:

- (2) The election in subsection (1) of this section applies to:
 - (a) Wages, salary and other compensation paid by the corporation, partnership, trust or estate to such officers, directors, shareholders, partners, members or beneficiaries to the extent the compensation is Idaho taxable income of the individual to whom it is paid; and
 - (b) The share of any income, loss, deduction or credit of an S corporation, partnership, trust or estate required to be included on such shareholder's, partner's, member's or beneficiary's Idaho return.
 - (c) When the gross income attributable to an individual under paragraphs (a) and (b) of this subsection (2) is less than the filing requirement of the individual under section 63-3030, Idaho Code, the income is not income under this subsection.

In 2010, 3022L was amended to remove residents, allow nonresidents with income from other Idaho sources to make the election, make the election irrevocable, and provided that the election was to be made in the manner prescribed in the rules of the Commission.¹³ However, these amendments were effective January 1, 2011, thus the statutory language in effect for taxable years ending June 30, 2009, and June 30, 2010, also applies to the petitioner's taxable year ending June 30, 2011.

Since neither party to this dispute argues for the inclusion of wages pursuant to 3022L(2)(a) or that the income is not Idaho source income pursuant to 3022L(2)(c), that leaves language contained in 3022L(2)(b) with which to contend.

The language contained within 3022L(2)(b), for all practical purposes, has remained the same since its codification in 1996. Unfortunately, "[t]he share of any income, loss, deduction or credit of an S corporation, partnership, trust or estate required to be included on such shareholder's, partner's, member's or beneficiary's Idaho return" does not provide specifics

¹² See 2001 Idaho session laws, ch. 270, sec. 4, p. 983.

¹³ See 2010 Idaho session laws, ch. 37, sec. 2, p. 67-8.

relating to the mechanics of the actual calculation. For that, the Commission will need to look elsewhere.

When reviewing the Commission's Idaho Income Tax Administrative Rules, it becomes apparent that a review of the Commission's historical interpretation of 3022L must be undertaken in order to explain the 3022L calculation for the taxable years at issue.

After the 1996 codification of 3022L, the Commission's 1997 Idaho Income Tax Administrative Rule 107.01 provided that "[a]n S corporation may be required to add the pass through items reportable as Idaho source income by a nonresident shareholder."¹⁴ Rule 107.01's language remained unchanged until 2001 when the language was moved from Rule 107 into Rule 290.02.b.i.. However, an additional paragraph was added, stating that "Pass-through items reportable to Idaho from an S corporation or a partnership for an Idaho part-year resident or nonresident are determined pursuant to Rule 263 of these rules."¹⁵

In 1997, Idaho Income Tax Administrative Rule 128.05 provided "Generally, a pass-through entity shall report the same Idaho adjustments as those allowed to the nonresident partner, shareholder, or beneficiary for whom the pass-through entity is paying the tax. However, a pass-through entity is not allowed a deduction for an Idaho net operating loss, a capital loss pursuant to Section 1212, Internal Revenue Code, an Idaho capital gains deduction, or any other adjustment that is not specifically allowed by statute or rule to an entity such as the one paying the tax."¹⁶ With one change, not pertinent to this discussion, Rule 128.05's language remained unchanged until 2009.¹⁷ In 2009, the Commission amended Rule 128.05 to be consistent with a

¹⁴ See IDAPA 35.01.01.107.01.b.i. (1997)

¹⁵ See IDAPA 35.01.01.290.02.b.iii. (2001)

¹⁶ See IDAPA 35.01.01.128.05 (1997).

¹⁷ See IDAPA 35.01.01.128.05 (2000) in which the word nonresident was changed to individual.

new position the Commission had taken in 2005 with respect to deductions allowed as part of the 3022L calculation.¹⁸ The Commission's 2005 change is discussed later in this decision.

For taxable years 1997 through 2011, an Idaho net operating loss, Idaho's capital gains deduction, and any capital loss carryover or carryback was excluded from the calculation of the 3022L tax. Until a change was made to the Commission's Income Tax Administrative Rules effective in 2007, the Idaho rules from 1997 forward did not identify the specific items of income and deductions to be included or excluded from the 3022L calculation; however, the Commission's Idaho Form 41S did. Prior to 2007, Idaho Form 41S was the primary vehicle that the Commission used to instruct taxpayers on the 3022L calculation.

The Idaho Form 41S instructions, for taxable years 1997 through 2003, began the 3022L calculation by having the entity identify the amount of "net distributable income" (one of the components in determining the amount of income subject to apportionment). Included within the "net distributable income" calculation were the following amounts from the S corporation's federal Schedule K:

- **Income and loss items federal Schedule K, lines 1 through 6:** Included within these lines was ordinary income or loss; net rental real estate income or loss, net income or loss from other rental activities, interest income, dividend income, royalty income net short-term capital gain or loss, net long-term capital gain or loss, net Internal Revenue Code (IRC) section 1231 gains or loss other than due to casualty or theft, other portfolio income, and other income.
- **Deductions from federal Schedule K, lines 7 through 10, and the lesser of line 11(a) or 11b(1) less 11b(2):** Included within the deductions was charitable

¹⁸ See IDAPA 35.01.01.128.05 (2009).

contributions, IRC section 179 expense, deductions related to portfolio income or loss, other deductions, and investment interest expense.

The deductions were reported on Idaho Form 41S, page 1, line 17. The separately stated research expense (reported as “other” on [Redacted] Schedule K, line 16, as an IRC section 52(e)(2) expenditure) was not included within the “net distributable income” determination. When making the 3022L calculation, the approach utilized by the Idaho form for taxable years 1997 through 2003 was simple and relatively easy to follow.

In 2004, the [Redacted] reorganized the S corporation’s [Redacted] Schedule K. Although the [Redacted] Schedule K was reorganized, the income and deductions previously included within “net distributable income” for 1997 through 2003 remained in the Idaho Form 41S calculation for 2004. For example, deductions such as charitable contributions and IRC section 179 expenditures remained on Idaho Form 41S, page 1, line 17. Although, the IRC section 59(e)(2) expenditures moved from the “other” category on the [Redacted] Form Schedule K into the “deductions” area of the [Redacted] form (that also housed the IRC section 179 and charitable contributions expenditures), the research expenditures were not included within those items making up the Idaho Form 41S “net distributable income”.

Beginning in 2005, the Commission’s interpretation of the 3022L calculation changed. On Idaho Form 41S, for taxable year 2005, the Commission eliminated the deductions that had been previously reported on Idaho Form 41S, line 17 as part of “net distributable income.” No explanation for the removal of the line 17 deductions was provided within the Idaho form 41S’s instructions for 2005, 2006, or 2007. However, in 2006, the Commission amended Rule 290, moving the 3022L calculation into a new Idaho Income Tax Administrative Rule 291, effective March 30, 2007; wherein, the Commission provided the following guidance:

04. Deductions That Are Subject to Limitations or Elections by Individuals. A pass-through entity is not allowed to deduct items that are subject to limitations or elections at the individual level. Examples of such items include the Section 179 deduction, research and experimental expenses, mining exploration and development costs, pre-productive period expenses, and passive activity losses. Individuals may not bypass limitations on deductions by electing to have the pass-through entity pay the tax.

05. Deductions That Are Not Allowed to S Corporations and Partnerships.

a. Capital Loss. As provided in Section 63-3022(i), Idaho Code, S corporations and partnerships are not allowed to carry over or carry back any capital loss provided for in Section 1212, Internal Revenue Code.

b. Net Operating Loss. As provided in Section 63-3022(i), Idaho Code, S corporations and partnerships are not allowed to carry over or carry back any net operating loss provided for in Section 63-3022(c), Idaho Code.

c. Nonbusiness Deductions. Deductions are not allowed for nonbusiness expenses of an individual, such as those claimed as itemized deductions, charitable contributions, or personal exemptions.

Underlining added.¹⁹

Not surprisingly, several S corporations, especially out-of-state S corporations, when filing the 2005, 2006, and 2007, Idaho Form 41S, were unaware that the deductions previously allowed since 1997, were no longer allowed as part of the 3022L calculation.²⁰ As such, some taxpayers simply reported the deductions on other lines when they filed the Idaho Form 41S for taxable years 2005 through 2007. The deductions were typically reported by taxpayers on Idaho Form 41S, page 1, line 33, “Other Subtractions”, especially since the specific instructions for that line stated that the taxpayer was to include “any deductions from separately stated items you are required to report.” The inclusion of these deductions in the 3022L calculation resulted in notice of deficiency determinations being issued, which in turn, generated protests. Some taxpayers

¹⁹ See IDAPA 35.01.01.291 (2007)

²⁰ The deductions were allowed as far back as 1989, when some of the concepts currently located within 3022L were contained within section 63-3022, Idaho Code, prior to the codification of 3022L in 1996.

argued that the disallowance of the various deductions went far beyond the statutory language and acted as a disincentive for nonresident individuals to utilize the simplified filing method.

As a direct result of protests, the Commission revisited its interpretation of 3022L and its decision to disallow the previously allowed deductions. Upon a closer examination of 3022L, the Commission concluded that the Rule 291 language was inconsistent with statutory language as it “inappropriately denies certain deductions that are generated by the pass-through entity and which would be allowed if the individual owner or beneficiary filed his own personal income tax return.”²¹ As such, the Commission passed a resolution in 2010, that replaced the language found in Rule 291.04 and .05(c) (see above) with a new approach to determine if a deduction should be included or excluded from the 3022L calculation.²² The new approach, implemented in 2010, survived subsequent legislative changes to 3022L and is currently found in Rule 291.03 through .04 as follows:

03. Deductions. Pass-through entities paying the tax under Section 63-3022L, Idaho Code, are not entitled to claim the following deductions on behalf of an individual.

a. Capital Loss. As provided in Section 63-3022(i), Idaho Code, S corporations and partnerships are not allowed to carry over or carry back any capital loss provided for in Section 1212, Internal Revenue Code.

b. Net Operating Loss. As provided in Section 63-3022(i), Idaho Code, S corporations and partnerships are not allowed to carry over or carry back any net operating loss provided for in Section 63-3022(c), Idaho Code.

c. Idaho Capital Gains Deduction. As provided in Section 63-3022H, Idaho Code, the Idaho capital gains deduction may only be claimed by individual taxpayers on an individual income tax return.

d. Informational Items. Amounts provided to owners of pass-through entities and beneficiaries of trusts and estates on the federal Schedule K-1 that are informational only may not be used as a deduction in computing the taxable income reportable under Section 63-3022L, Idaho Code. Informational

²¹ Idaho State Tax Commission Resolution 10-05, dated July 21, 2010.

²² *Id.*

items include the domestic production activities information and net earnings from self-employment.

e. **Items Not Deductible Under the Internal Revenue Code.** A deduction is not allowed for items disallowed under the Internal Revenue Code. For example, a deduction is not allowed for items disallowed as a deduction in Sections 162(c) and 262 through 280E, Internal Revenue Code, unless specifically allowed by Idaho law. Items allowed by Idaho law include expenses related to tax-exempt income under Section 265, Internal Revenue Code, which are allowed to be deducted as a result of Section 63-3022M, Idaho Code.

f. **Items Not Reported as a Pass-Through Deduction.** Amounts not reported from the pass-through entity to the pass-through owner are not allowed as a deduction under Section 63-3022L, Idaho Code. These include:

i. The standard deduction;

ii. Personal exemptions;

iii. Itemized deductions that result from activity of the pass-through owner. For example, a deduction is not allowed for charitable contributions made personally by the pass-through owner, but is allowed for the pass-through owner's share of charitable contributions made by the pass-through entity.

04. **Double Deductions Disallowed.** A pass-through owner may not deduct amounts that previously have been deducted by a pass-through entity paying the tax on his behalf. If the pass-through owner files an Idaho individual income tax return reporting federal taxable income that includes amounts previously deducted by a pass-through entity on his behalf, the pass-through owner must add back the duplicated deduction amounts in computing his Idaho taxable income on his individual income tax return.

It is this language that the Commission will apply to determine if the petitioner is entitled to include the research expenses within the 3022L calculation. However, prior to applying Rule 291's language to the research expenses, the Commission will first review how the petitioner reported the research expenditures.

IRC section 59(e) allows each shareholder to make an election to deduct their pro rata share of the corporation's otherwise deductible qualified IRC section 174 research expenses ratably over 10 years rather than as a current deduction; therefore, the corporation cannot deduct

these amounts or include them as [Redacted] items on Schedule K-1. Instead, the corporation must treat the research and development costs as a separately stated item.²³

Using taxable year ending June 30, 2010, as an example, the petitioner incurred \$1,403,239 of qualified research expenses.²⁴ The petitioner reduced “other costs” included within cost of goods sold by \$1,262,915.²⁵ The petitioner reduced “other deductions” by the \$140,324, difference between the \$1,403,239 and \$1,263,915.²⁶ The reasoning for the \$140,324 reduction is discussed below. Thus, when calculating its ordinary business income for taxable year ending June 30, 2010, the petitioner removed the entire \$1,403,239 of research expenses.

The petitioner reported research expenses of \$1,262,915 on [Redacted] Schedule K as a shareholders’ separately stated IRC section (59)(e)(2) deduction.²⁷ Each shareholder’s distributive share of the \$1,262,915 research expenses is reflected on that shareholder’s [Redacted] Schedule K-1.²⁸ Each of the petitioner’s shareholders made their own decision on amortizing the research expenses pursuant to IRC section (59)(e)(2) or to deduct the research expense on the shareholder’s [Redacted] return as a current expense.

In addition to deducting research expenses, [Redacted] law provides for a “credit for increasing research activities.”²⁹ The credit is generally allowed for expenses paid or incurred for qualified research expenses.³⁰ The petitioner filed [Redacted] Form 6765, Credit for Increasing Research Activities, to claim the credit. The credit is treated as a separately stated

²³ IRC section 1366(a)(1)(A).

²⁴ Federal Form 6765, Credit for Increasing Research Activities, Section A-Regular Credit, line 9.

²⁵ Federal Form 1120S, page 2, Schedule A – cost of goods sold, line 5, white paper detail.

²⁶ Federal Form 1120S, page 1, line 19 – other deductions, white paper detail.

²⁷ Federal Form 1120S, page 4, Schedule K – Shareholders’ Pro rata Share Items, line 12c – other deductions.

²⁸ Federal Form 1120S, Federal Schedule K-1’s, line 12 – other deductions.

²⁹ IRC section 41.

³⁰ IRC section 174.

item.³¹ The petitioner reported the amount of the credit on 1120S [Redacted] Schedule K and reported each shareholder's portion on the shareholders [Redacted] Schedule K-1.³²

When calculating the credit, the petitioner opted to use the regular credit method rather than the alternative simplified credit method. If the regular credit method is utilized, no research expense deduction is allowed for the value of the credit by either the petitioner or its shareholders.³³ Again, using taxable year ending June 30, 2010, as an example, the regular credit method resulted in a credit amount of \$140,324. Accordingly, the petitioner reduced "other deductions" by \$140,324 in arriving at ordinary business income or loss and did not include that amount as part of the research expenses treated as a separately stated item on the petitioner's [Redacted] Schedule K. Thus, the question remains what amount, if any, of the research expenses are included within the 3022L calculation.

Rule 291 is primarily structured to identify those deductions that are excluded from the 3022L calculation, rather than what deductions are included. The deductions not allowed are addressed in Rule 291.03 and Rule 291.04. The present case does not involve those types of deductions disallowed by Rule 291.03.a through 03.c. and .03.f. (see above). Since, the petitioner is not trying to claim the research expenses twice, nor is there any evidence to show that the shareholders are attempting to "double deduct" the research expenses, Rule 291.04 is inapplicable as well. That leaves the language contained within Rule 291.03.d and 03.e.

Rule 291.03.e does not allow an expense that is not allowed as a deduction under the IRC. The reduction in the amount of research expenses due to the petitioner's use of the regular method rather than the alternative simplified method when calculating the "credit for increasing

³¹ IRC section 1366(a)(1)(A).

³² Federal Form 1120S, page 4, Schedule K – Shareholders' Pro rata Share Items, line 13g – other credits and federal Schedule K-1's, line 13 – credits.

³³ IRC section 280C(c)(3).

research activities” is a deduction that is not allowed under the IRC.³⁴ As previously mentioned, the deduction is neither allowed to the petitioner nor included within the research expense amount passed through to the shareholders. Therefore, the petitioner should not have included the disallowed research expenses associated with the research credit amounts in the amounts of \$118,591, \$140,324, and \$51,573, for taxable years June 30, 2009, June 30, 2010, and June 30, 2011, respectively, within the 3022L calculation.

The petitioner reported research expenses on its [Redacted] Schedule K as a separately stated item in the amount of \$1,067,324, \$1,262,915, and \$930,177 for taxable years ending June 30, 2009, June 30, 2010, and June 30, 2011, respectively. Since research expenses are expenses allowed under the IRC, Rule 291.03.e does not apply. The analysis now falls to Rule 291.03.d.

Research expenses are not explicitly addressed in Rule 291.03.d or, for that matter, anywhere within Rule 291; however Rule 291.03.d does provide some guidance. If the research expenses are viewed as just an “informational item” similar to the domestic production activities or net earnings from self-employment information, the expenses cannot be included within the 3022L calculation.

Unlike most partnership income, S corporation income is not self-employment income and is not subject to self-employment tax. However, understanding why Rule 291.03.d explicitly lists self-employment information as excluded from the 3022L calculation may provide insight in understanding if the research expenses should be treated as an “informational item.”

The information provided on a partnership’s [Redacted] Schedule K relating to net earnings from self-employment consists of various income and deductions that are already included within the partnership’s ordinary business income or loss, as well elsewhere on the

³⁴ *Id.*

partnership's [Redacted] Schedule K. Idaho Form 65's calculation of "net distributable income", in most situations, would have already included that income and deductions within its calculation. A partner, that is an individual, simply uses the net earnings from self-employment information to determine the partner's self-employment deduction on the partner's individual income tax return.

The other item listed as an "informational item" is domestic production activities. A partnership or S corporation does not compute the domestic production activities deduction, but must provide its owners with the information the partner needs to compute the deduction on federal Form 8903. Depending on the circumstances, the partnership or S corporation will calculate the amount of "qualified production activities income" and qualifying [Redacted] Form W-2 wages at the partnership level and report these amounts to its qualified partners, or the pass-through entity provides its owners with a laundry list of information, including the W-2 information, necessary for the partner to calculate the "qualified production activities income" at the partner level. The partner then calculates the amount of qualified production activities deduction to be deducted on the partner's [Redacted] income tax return. Similar to the calculation of net-earnings from self-employment, the information provided relating to the domestic production activities represents income and deductions already reported elsewhere on the [Redacted] Schedule K and in most situations, already included within Idaho's calculation of "distributable net income."

Given that the research expenses at issue in this docket are excluded from the calculation of the petitioner's ordinary business income or loss, and passed through as a separately stated deduction to the shareholders, much in the same way as deductions for charitable contributions

or IRC section 179 expenditures, the Commission finds that the research expenses do not fall under Rule 291.03.d's disallowance as an "informational item."

Although Rule 291 is silent with respect to IRC section 179's inclusion within the 3022L calculation, charitable contributions are addressed within an example contained within Rule 291.03.f. as follows:

For example, a deduction is not allowed for charitable contributions made personally by the pass-through owner, but is allowed for the pass-through owner's share of charitable contributions made by the pass-through entity.

Underlining added.

Additionally, the Commission recently added language to the Idaho Form 41S instructions explicitly allowing for the inclusion of charitable contributions and IRC section 179 expenses within the 3022L calculation.³⁵

The treatment of the research expenses seems similar to that of charitable contributions and IRC section 179 expenditures, rather than information relating to net earnings from self-employment or the domestic production activities; thus, the Commission finds that the research expenses, excluding that portion of the research expenses not allowed as a deduction (see discussion above), should be included within the 3022L calculation. Since the Commission finds that the research expenses are allowed in computing the 3022L calculation, the Commission need not address the section 63-3022, Idaho Code, modification position taken in the NODD.

Based upon the Commission's finding above, a small amount of research expenses was included within the 3022L calculation that should not have been. However, since the petitioner had a "net distributable loss" for one of the tax years and that the petitioner did not include

³⁵ Idaho Corporate Income Tax Instruction booklet for taxable year 2013, page 12, line 18 – Other Items.

allowable charitable contributions within the 3022L calculation, given the immateriality of the amounts at issue in this docket, the Commission simply withdraws the NODD.³⁶

THEREFORE, the NODD dated January 12, 2011, and directed to the petitioner is hereby CANCELLED by this decision.

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

DATED this _____ day of _____ 2014.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2014, 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.

³⁶ Idaho Administrative and Enforcement Rule 325.06 states "Redetermination of any tax or refund due is not limited to the specific issue or issues protested for the taxable year, unless limited by Section 63-3068(f), Idaho Code."

Table 1	6/30/2009	6/30/2010	6/30/2011
Ordinary income	-\$6,065,158	\$8,248,962	\$8,243,328
Capital gain (unrecaptured sec. 1250 gain)		104,147	
State loss on [Redacted]			56,262
Bonus depreciation	3,927,390		1,054,613
[Redacted] state tax			14,497
Charitable contributions			
Section 174 research expenses	-1,067,324	-1,262,915	-930,177
Research credit	-118,591	-140,324	-51,573
State and local tax refunds	-2,090		
State adjustment on disposition of assets	-2,404		
Bonus depreciation		-859,982	
Business income subject to apportionment	-3,328,177	6,089,888	8,386,950
Idaho apportionment factor	3.9745%	3.6032%	3.0174%
Income apportioned to Idaho	-132,278	219,431	253,068
Income allocated to Idaho			
Income reported to Idaho by shareholders			
Income included within composite return	-132,278	219,431	253,068
Idaho corporate tax rate	7.6%	7.6%	7.6%
Income tax paid on behalf of shareholders	0	16,677	19,233
Idaho investment tax credit allowed		-8,339	-9,617
[Redacted] paid on behalf of shareholders	20	20	20
Total tax paid on behalf of shareholders	20	8,358	9,636
Minimum tax on S corporation (petitioner)	20	20	20
Net tax after business income tax credits	40	8,378	9,656
Estimated tax payments	-9,132	-11,092	-12,900
Estimated tax payments applied to next year	9,092	2,714	3,244
Net tax due/(refund issued)	\$0	\$0	\$0