

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-096-633-856
)	1-761-444-864
)	
Petitioners.)	DECISION
<hr style="width: 45%; margin-left: 0;"/>)	

(Petitioners) protested the Notice of Deficiency Determination dated March 24, 2022, asserting additional income tax, penalty, and interest for tax years 2017 through 2020. Petitioners initially only disagreed with the Income Tax Audit Bureau’s (Bureau) flow-through adjustment for depreciation. However, after the Bureau later split up the years and sent them modified Notices of Deficiency Determination, Petitioners also disagreed with the Bureau’s determination of distributions in excess of basis from an S-Corporation Mr. owned. The Tax Commission, having reviewed the file, hereby upholds the modified Notices of Deficiency Determination dated February 10, 2023.

BACKGROUND

Among other entities, Mr. is a twenty-five percent owner of (an Idaho S-Corp; (an Idaho partnership; and (an Idaho partnership. The Bureau reviewed corporate income tax return for the tax year 2018 and found had substantial bonus depreciation additions flowing through to its shareholders. The Bureau also found that made substantial distributions to its shareholders in 2018. The Bureau reviewed Petitioners’ individual income tax returns and found that Petitioners did not add back the bonus depreciation as required. The Bureau reviewed Petitioners’ and surrounding returns, 2017 through 2020, and found the bonus depreciation additions and subtractions were not

made on Petitioners' income tax returns, and that Mr. _____ may not have had enough basis in _____ to exclude the distributions from their income. The Bureau also reviewed _____ and _____ returns and found Petitioners did not include the bonus depreciation additions and subtractions for those entities either. The Bureau's review also revealed that Petitioners did not avail themselves of the qualified business income (QBI) deduction.

Due to time constraints on Petitioners' 2018 income tax return, the Bureau computed Mr. _____ basis in _____ based on the information provided on _____ corporate returns and determined Mr. _____ basis in _____ for 2018 was insufficient for the distributions to be treated as a return of capital (non-taxable). The Bureau adjusted Petitioners' 2017, 2018, 2019, and 2020 income tax returns for the bonus depreciation additions and subtractions, adjusted Petitioners' 2018 and 2019 returns for distributions in excess of basis, and allowed a deduction for QBI. The Bureau sent Petitioners a Notice of Deficiency Determination that Petitioners protested. Petitioners provided additional information with their protest that the Bureau reviewed and determined the Notice of Deficiency Determination should be divided into two notices, one for 2017 and 2018 and the other for 2019 and 2020. The Bureau modified the original Notice of Deficiency Determination and sent Petitioners two separate Notices of Deficiency Determination. Petitioners did not withdraw their protest, but rather continued it.

Petitioners' initial protest agreed with the Bureau's adjustment for the distribution in excess of basis. Petitioners disagreed with the depreciation adjustments. However, after the Bureau modified its determination, Petitioners disagreed with both the bonus depreciation adjustments and Idaho's ability to tax the distributions in excess of basis. Petitioners stated they made the required bonus depreciation additions and subtractions on their filed returns. Petitioners provided an analysis of their additions and subtractions. In relation to the bonus depreciation adjustment made

for tax year 2017, Petitioners stated that the adjustment cannot be made because the year is closed due to the statute of limitations. Regarding the distributions in excess of basis, Petitioners stated the distributions inure to the state of residence which in this case is California. The only adjustment Petitioners agreed with was the Bureau's determination of the QBI deduction.

The Bureau acknowledged Petitioners' protest and referred the matter to the Tax Commissions Appeals Unit (Appeals) for administrative review. Appeals reviewed the matter and sent Petitioners a letter that discussed their options for redetermining a protested Notice of Deficiency Determination. Petitioners requested a telephone hearing which was held on December 8, 2022. In attendance at the hearing was _____ CPA, Petitioners' representative (Representative), and hearing the case were Commissioner _____ and _____ Tax Appeals Specialist.

During the hearing Representative presented Petitioners' position. Representative stated Petitioners are not contesting the adjustments to 2019 and 2020 since the amounts are so small. Representative stated they are more concerned with 2018 and that year is their focus. Representative stated the audit staff is asserting that Petitioners did not make the bonus depreciation additions and subtractions. Representative stated he entered the information into the software and the software did its thing. Representative stated he started with the federal schedules K-1 income or loss and added or subtracted the federal bonus depreciation and state depreciation for the three entities for the total reported and on the tax return. Representative stated the full loss was not claimed for _____ because it exceeded Mr. _____ basis in the entity. Representative stated they netted the income or loss with the additions and subtractions of the bonus depreciation for each of the three entities. The three entities combined are what is reported on Petitioners' Idaho returns. However, when compared with Representative's analysis, the amount reported on

Petitioners' 2018 return is \$28,110 less than the amount shown in the analysis. Representative stated he would contact his software company to see why the numbers entered into the software did not net out correctly on the Idaho return. Representative stated that since Petitioners did not claim the full amount of the loss from _____ on their 2018 federal income tax return, this probably accounts for the discrepancy between the amount shown on the return and Representative's analysis.

We briefly talked about the 2017 return and that Idaho has a statute, Idaho Code section 63-3022O(5), that allows adjustments in otherwise closed years for bonus depreciation. Representative was unfamiliar with that section of the Idaho Code, so a copy of that section was sent to him.

Next, Representative stated their position on the distribution in excess of basis. Representative stated the audit staff, when computing basis, used all federal numbers and made no account of the state's addbacks and subtractions. Representative stated the basis calculation should take into account the differences in Idaho law versus federal law. Representative also argued that since federal law treats distributions in excess of basis as gain from the sale or exchange of property, in this case stock, an intangible, the gain is only reported to the individual's state of residence. Appeals pointed out that Idaho law, Idaho Code section 63-3026A(3)(a)(vii), considers gains and losses from the sale or other disposition of stock in an S-Corporation Idaho source income. Appeals stated they would provide copies of the Idaho code sections for computing a shareholder's basis and the treatment of distributions as Idaho source income.

After the hearing, Representative provided additional information regarding the differences in his reconciliation and the 2018 return. Representative stated the amount carried to the Idaho returns was not the amount reported on the schedule K-1. The amount reported on the return is a

combination of _____ loss that did not exceed Mr. _____ basis and depreciation that did not exceed Mr. _____ basis. Representative stated based on this computation, Petitioners' income is less than what was reported on the 2018 return.

Appeals provided Representative with copies of the Idaho code sections that spoke to the bonus depreciation adjustments, the 2017 statute of limitations, and treating S-Corporation distributions as Idaho source income. Appeals also asked Representative to verify whether Mr. _____ made loans to _____ for the debt basis the Bureau attributed to Mr. _____.

Representative responded that based on his calculations there are no deficiencies for tax year 2018. Representative also stated from the information provided, it appears that the statute of limitations revisions regarding bonus depreciation were not passed until 2021-2022 and only allowed 2017 to be open for taxable loss issues. Representative stated the Idaho entities did not have taxable losses in 2017, so it seems the statute of limitations is closed for 2017. Representative provided a revised calculation for 2018 showing a net reduction in the income reported by the Idaho entities. However, Representative did not address the questions regarding any loans Mr. _____ made to _____.

During the review of Mr. _____ basis in _____ Appeals found that the Bureau attributed debt basis to Mr. _____ in 2018. This prompted the questions to Representative about loans from Mr. _____ to _____. A review of _____ corporate income tax return showed no recording of loans from shareholders on the balance sheet. Considering this and that Representative provided no information on loans from Mr. _____ Appeals determined the basis calculation the Bureau made for Mr. _____ in _____ was incorrect. Appeals sent the case back to the Bureau to recalculate Mr. _____ basis without any debt basis. The Bureau did the calculation which resulted in an increase to Petitioners' tax based on the Bureau's previous

determinations. The Bureau sent Petitioners a second set of modified Notices of Deficiency Determination and informed them that this second modification is now part of their protest.

Representative responded to the second modification stating that the Tax Commission's representatives continue to miss the obvious in the computation of Mr. basis in

Representative stated Internal Revenue Code (IRC) section 465 limits losses to the amount at risk, which is usually the basis. Representative stated they correctly applied the at-risk limitations to

loss shown on schedule K-1. Representative stated the auditor and Appeals continue to ignore IRC section 465 and make a hypothetical adjustment which results in a distribution in excess of basis. Representative stated the Tax Commission is applying the entire loss reported on schedule K-1 to the basis computation rather than the amount claimed on Petitioners' federal return. Representative stated the Tax Commission is not following the federal rules for computing basis. Representative stated the amount to be included is the amount claimed, not the amount reported on schedule K-1.

Regarding the bonus depreciation adjustments, Representative stated the Tax Commission is adding back federal bonus depreciation that was not claimed on the Idaho return. As such, the Tax Commission is not following the IRC section 465 limitations. Representative stated that if Idaho is ignoring the law and opened up 2017 on that basis, the state is barred by the statute of limitations from doing so.

LAW AND ANALYSIS

Idaho Code section 63-3002 states that the provisions of the Idaho income tax act, insofar as possible, are to be identical to the Internal Revenue Code relating to the measurement of taxable income, subject to the modifications in the Idaho law. Idaho Code section 63-3022O stated in pertinent part, "the . . . depreciation . . . of depreciable property . . . shall be computed without regard

to subsection (k) of section 168 of the Internal Revenue Code”. IRC section 168(k) requires, unless elected out, additional depreciation allowance on qualified property, commonly called bonus depreciation. Idaho law requires depreciation to be computed without regard to IRC section 168(k), therefore, Idaho taxpayers are required to make additions or subtractions to depreciation on their Idaho returns. In this case, _____ and _____ reported the depreciation as required by IRC section 168(k). These entities provided that information to their shareholders and/or partners on schedules K-1 so their owners could make the appropriate additions and subtractions on their personal Idaho income tax returns. Petitioners stated they netted the additions and subtractions and reported the amount on schedule E. However, when asked to show how the amount was determined for _____ Representative stated depreciation was only claimed on the return that did not exceed Mr. _____ basis. Representative stated Idaho is ignoring the at-risk rules of IRC section 465 by adding the full amount of the bonus depreciation rather than the amount that was claimed on Petitioners’ return.

Idaho Code section 63-3022O(2) gave instructions on the adjustments for bonus depreciation. It stated that Idaho taxable income shall be determined without regard to the loss limitations of IRC sections 465, 469, 704(d), and 1366(d). In effect, section 63-3022O(2) provided for the full addition and subtraction of the bonus depreciation claimed for federal tax purposes regardless of the limitations for at-risk or basis. In this case the bonus depreciation claimed by Mr.

_____ flow-through entities, _____ and _____

Petitioners incorrectly reported the bonus depreciation additions and subtractions; therefore, the Tax Commission finds the adjustments made for tax years 2018, 2019, and 2020 for bonus depreciation should stand.

The Bureau also adjusted bonus depreciation for tax year 2017. Petitioners argue that this adjustment cannot be made because of the statute of limitations, the year is closed. However, Idaho Code section 63-3022O provides a limited exception to the statute of limitations in the case of bonus depreciation. Subsection (5) of section 63-3022O states, the period of limitations for issuing a notice of deficiency determination or filing a claim for refund for any year for which an adjustment is required for bonus depreciation shall not expire before three years from the later of: (a) the due date of the return for the last taxable year an adjustment was required; or (b) the date the return was filed for the last taxable year an adjustment was required. It states further that if the general statute of limitations has expired, only the specific items of basis, deductions, gains, or losses that are computed without regard to IRC section 168(k), as required by section 63-3022O, shall be subject to adjustment. Therefore, the Tax Commission upholds the adjustment to Petitioners' 2017 income tax return for the bonus depreciation additions and subtractions.

Petitioners disagreed with the Bureau's determination that the 2018 distributions from [redacted] are taxable. The Bureau stated that based on its calculations the 2018 distributions were in excess of Mr. [redacted] basis and therefore taxable.

IRC section 1368 states that distributions in excess of basis from S-Corporations are considered to be a sale or exchange of property, the gain from which is reported as capital gain income. If a shareholder has a zero basis for the tax year and receives a distribution from the S-Corporation, the distribution is a distribution in excess of basis and therefore, is included in the shareholder's income.

S-Corporation basis is determined by the rules of IRC section 1367 which takes into account the shareholder's pro rata share of the corporation's items of income, loss, deduction, or credit, and non-separately computed income or loss. Generally, a shareholder's basis is tracked by

the entity and should be tracked by the shareholder. The last schedule the Tax Commission received tracking Mr. [REDACTED] basis in [REDACTED] was filed with [REDACTED] 2009 return. Therefore, the Bureau computed Mr. [REDACTED] basis beginning with tax year 2010. The Bureau used the information [REDACTED] reported on its corporate income tax returns for each year through 2020.

For tax year 2018, Mr. [REDACTED] basis in Meridian was \$0 with a suspended loss carryover of \$20,495. (Suspended losses occur when a shareholder's proportionate share of the S-Corporation's income or loss is a loss, and the shareholder has no basis in the S-Corporation.)

[REDACTED] operations in 2018 resulted in a loss. Mr. [REDACTED] proportionate share of the loss was \$77,705. Mr. [REDACTED] basis remained at \$0 but his suspended loss carryover increased to \$98,200. Because Mr. [REDACTED] basis was \$0 for 2018, Petitioners could not claim a loss from [REDACTED] on their 2018 individual income tax return. However, Petitioners did report a loss from [REDACTED] in the amount of \$46,554. Representative explained this loss as a combination of the allowable loss, not in excess of basis, and the allowable section 179 depreciation, not in excess of basis. Representative argued these amounts are allowed under the at-risk rules of IRC section 465. However, Representative did not provide a calculation showing Mr. [REDACTED] had amounts at-risk at the beginning of 2018.

IRC section 465 defines the activities subject to the at-risk limitation rules. [REDACTED] activity falls into the catch-all activities category of a trade or business, or an activity engaged in for the production of income. Amounts at-risk are defined in IRC section 465 as the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and amounts borrowed with respect to such activity. In this case, beginning with tax year 2010, Mr. [REDACTED] contributed to, or [REDACTED] generated income giving Petitioners a basis of \$489,595, Mr. [REDACTED] at-risk amount. From 2010 to 2017, [REDACTED] operations yielded income and losses to [REDACTED]

Mr. [redacted] and Mr. [redacted] took distributions or returns of his capital (his investment) that left him with a negative basis in [redacted] an at-risk amount of less than zero. Therefore, because of IRC section 465 at-risk limitations and the rules for computing basis, IRC section 1367, Mr. [redacted] tax basis in [redacted] at the end of 2017 was \$0. Because Mr. [redacted] basis in [redacted] at the beginning of 2018 was \$0 and [redacted] generated a loss for tax year 2018, Petitioners cannot claim any of [redacted] 2018 loss on their individual income tax return.

Representative stated a portion of the loss was for section 179 depreciation. The problem with that is [redacted] did not claim section 179 depreciation. [redacted] claimed the bonus depreciation of section 168(k) and reported the proper addback and subtraction for each of its shareholders.

The character of the depreciation is established at the entity level. Petitioners cannot change the character to benefit them personally. The depreciation is bonus depreciation and must be treated accordingly.

Mr. [redacted] received a distribution from [redacted] in 2018. Since we have already established that Mr. [redacted] had a zero tax basis, the distribution is treated as a sale or exchange of property, the gain from which is income to Mr. [redacted] and should be included in Petitioners' Idaho income. Representative argued that Idaho does not have a right to the income because it is the sale of an intangible (stock) which generally follows the individual's state of domicile, in this case California. However, Idaho Code section 63-3026A(3)(a)(vii) provides that gains and losses from the sale or other disposition of stock in an S-Corporation is considered derived from Idaho sources to the extent of the S-Corporation's Idaho apportionment factor. [redacted] apportionment factor for the years under review was 100 percent. Therefore, since distributions in excess of basis are

considered the sale or exchange of property, per IRC section 1368, the distributions Mr. [redacted] received from [redacted] are considered Idaho source income and taxable by Idaho.

Representative further argued that Idaho should use a different basis computation because of the required addbacks and subtractions for bonus depreciation. However, Idaho Code section 63-3022O(3) (2018) stated, “A taxpayer’s basis in an interest in a pass-through entity, amount at-risk, and passive activity loss carryover shall be the same amount. . . as the amount determined under the Internal Revenue Code.” Therefore, Mr. [redacted] basis in [redacted] for Idaho tax purposes is the same as his basis for federal tax purposes.

Finally, Representative contested the Tax Commission’s ability to open other issues or to increase the audit results. During the Tax Commission’s redetermination of the Bureau’s basis calculation for Mr. [redacted] the Tax Commission found that the Bureau attributed debt basis to Mr. [redacted] that did not appear on [redacted] returns. When Representative was asked to substantiate Mr. [redacted] debt basis, nothing was provided.

IDAPA 35.02.01.325 Tax Commission Administrative and Enforcement Rules states that a redetermination is not limited to the specific issue or issues protested. When Petitioners failed to substantiate a debt basis, Appeals sent the matter back to the Bureau to recompute Mr. [redacted] basis in [redacted] without the debt basis. Because Petitioners did not meet their burden of establishing a basis in [redacted] the Tax Commission finds it appropriate that the Bureau recomputed Mr. [redacted] basis without the debt basis that was previously attributed to Mr. [redacted]

CONCLUSION

Mr. [redacted] is a shareholder and partner in an S-Corporation and two partnerships that are located in Idaho and only do business in Idaho. The Idaho entities claimed bonus depreciation on their federal income tax returns. Because the entities are pass-through entities, Petitioners must

report the flow-through attributes of income, loss, deductions, and credits on their individual income tax return. Idaho does not follow the federal bonus depreciation deductions; therefore, individuals and businesses must make the proper adjustments to their Idaho income tax returns. Petitioners did not make all the adjustments as required. Therefore, the Tax Commission upholds the Bureau's adjustments for bonus depreciation.

Mr. [redacted] received distributions from the S-Corporation, [redacted] over the years of their ownership. Generally, distributions are non-taxable returns of a capital investment. However, when a shareholder has recouped all of their basis through distributions or claiming losses from the entity, distributions become taxable as a sale or exchange of property. Mr. [redacted] received distributions from [redacted] in excess of their basis. Petitioners did not establish a basis other than the amount determined by the Bureau, which for 2018 was zero. Therefore, the Tax Commission upholds the Bureau's adjustment to include Mr. [redacted] 2018 distribution from [redacted] in Idaho taxable income.

The Bureau added interest and penalty to Petitioners' Idaho tax. The Tax Commission reviewed those additions and found them appropriate and in accordance with Idaho Code sections 63-3045 and 63-3046, respectively. Interest is computed to July 19, 2023.

THEREFORE, the modified Notices of Deficiency Determination dated February 10, 2023, directed to [redacted] are AFFIRMED.

IT IS ORDERED that Petitioners pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2017	\$2,229	\$111	\$ 407	\$ 2,747
2018	8,722	436	1,220	10,378
2019	376	19	40	435
2020	(1,718)	0	(123)	<u>(1,841)</u>
			TOTAL	\$11,719
			REMITTED	<u>13,125</u>
			REFUND	\$1,406

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

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

DATED this _____ day of _____ 2023.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2023,
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:

Receipt No.
