BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
) DOCKET NO. 0-153-453-568
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)
Petitioners.) DECISION
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(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 disagreed with the additional income the Income Tax Audit Bureau (Bureau) added to their 2018 and 2019 Idaho individual income tax returns for distributions in excess of basis from an S-Corporation (S-Corp) owned by Mr. The Tax Commission, having reviewed the file, hereby modifies the modified Notice of Deficiency Determination dated March 17, 2023.

BACKGROUND

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 that 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' 2018 individual income tax return and found that Petitioners did not addback and subtract 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 those returns, and that Mr. may not have had enough basis in to exclude the distributions from their income. The Bureau reviewed and returns and found Petitioners did not include the bonus depreciation additions and subtractions for those entities as well. The Bureau's review also included Petitioners' claim of the qualified business income (QBI) deduction.

Due to time constraints on Petitioners' 2018 income tax return, the statute of limitations about to expire, the Bureau computed Mr. basis in based on the information provided on corporate returns. Based on that information, the Bureau found Mr. did not have sufficient basis in for the 2018 distribution to be treated as a return of capital (non-taxable). The same was true for the 2019 distribution from

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 adjusted Petitioners' QBI deduction to their proportionate share of Idaho income. The Bureau sent Petitioners a Notice of Deficiency Determination that they protested.

Petitioners stated they disagreed with the additional income added to their 2018 and 2019 income tax returns. Petitioners stated they disagreed with the determination that the distributions from were in excess of Mr. basis in And, even if Mr. had no basis in at the time of the distributions, the distributions would be treated as the sale of an intangible which is only taxable by his state of domicile, Arizona. Petitioners also stated that the Bureau's computation of Mr. basis did not use the adjustments for Idaho income, but rather used the federal adjustments. Petitioners did not mention any disagreement with the bonus depreciation adjustments or the QBI deduction adjustments.

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' representative (Representative) a letter that discussed the options for redetermining a protested Notice of Deficiency Determination. Representative did not respond.

Appeals did a more comprehensive review of the matter and found that the Bureau attributed debt basis to Mr. in 2018. This prompted questions about loans from Mr. to A review of corporate income tax return showed no record of loans from shareholders on the balance sheet. Seeing this, 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 over the Bureau's previous determination. The Bureau sent Petitioners a modified Notice of Deficiency Determination and informed them that this modification was now part of their protest. Shortly thereafter, Appeals sent Petitioners a follow-up letter to its initial contact letter asking how they wanted to proceed with their protest.

Rather that responding to Appeals, Representative responded to the Bureau regarding the modified Notice of Deficiency Determination stating he was unsure of what he needed to do to protest the modification. Representative also argued that Petitioner did not have a loss from after accounting for the bonus depreciation adjustments required by Idaho. The Bureau referred Representative to Appeals since Petitioners' case was sent to Appeals when Petitioners filed their original protest.

Representative emailed Appeals for clarity on whether a second protest was needed because of the modified audit report, and to argue that for Idaho purposes, even if Mr. had no debt basis in the loss from should be netted with the bonus depreciation adjustments yielding a small gain. Appeals replied making it clear that a second protest was not needed. Appeals provided Representative with an explanation of how basis is determined for Idaho purposes and that the bonus depreciation adjustments do not affect the basis calculation. Appeals asked Representative to provide a basis calculation for Mr. and informed him that Petitioners have the right to a hearing if one is desired. Appeals asked Representative to respond by the date given in its follow-up letter on how he and Petitioners wanted to proceed.

Shortly after that date, Representative sent Appeals an email stating how income/loss should be reported to Idaho for 2018. Representative agreed that the loss Petitioners reported for federal income tax purposes is suspended, but he believes for Idaho purposes the state should be netting the bonus depreciation adjustments against the loss to arrive at Idaho taxable income. Representative stated by using the Idaho adjustments the result for is that the shareholders have a net income. Representative stated he would provide a worksheet showing his computations, however, that worksheet was never provided. Representative also stated that by suspending loss, Petitioners' QBI deduction increases since the loss is not considered qualified business income. Representative asked Appeals to consider this information for further discussion.

Appeals reviewed the information Representative provided and responded with information on how basis is calculated for Idaho purposes. Appeals stated that Idaho uses the same basis calculation as provided in the Internal Revenue Code (IRC) and that the bonus depreciation adjustments do not affect basis. Appeals stated that because loss was not suspended, the loss needed to be added back into income and then the additions and subtractions made for bonus depreciation. As for the 2018 QBI calculation, Appeals stated it is a federal calculation that Idaho allows as a deduction. And, since the loss is treated the same for Idaho as it is for federal, the deduction should not change from the original amount claimed. Appeals asked Representative to call in the next day or so to discuss it further.

Representative did not call, so after a few months Appeals e-mailed Representative asking if there was anything further he wanted the Tax Commission to consider. Representative responded that he needed some time to see where we left off and to discuss it with Petitioners. Representative asked that he be given until December 15, 2023, to respond. Appeals allowed Representative the additional time.

Come December 15, 2023, Representative did not contact Appeals or provide anything more for consideration. Appeals e-mailed Representative a couple of days later but received no response. Seeing that Petitioners and Representative have had more than adequate time and opportunity to further argue their position, the Tax Commission decided the matter based on the information provided.

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 and subtractions to account for bonus depreciation on their Idaho returns. In this case,   and   reported bonus 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 did not report Mr. share of the bonus depreciation additions and subtractions on their individual income tax returns. The Bureau adjusted Petitioners' returns for the bonus depreciation additions and subtractions. Petitioners did not protest these adjustments.

The Bureau adjusted Petitioners' 2018 and 2019 returns for distributions in excess of basis. The distributions were from The Bureau stated that based on its calculations, Mr. had no basis in in 2018 and 2019; therefore, the distributions are taxable. Petitioners disagreed that the distributions are taxable by Idaho. Petitioners stated that for state tax purposes, income from the sale of an intangible asset, in this case stock, is taxed to the state where the taxpayer is domiciled, in this case Arizona.

IRC section 1368 states that distributions in excess of basis from S-Corps are considered to be a sale or exchange of property, the gain from which is reported as capital gain income. If a shareholder has no basis for the tax year and receives a distribution from an S-Corp, the distribution is a distribution in excess of basis and therefore, is included in the shareholder's income.

S-Corp 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. basis in was filed with 2009 return. Therefore, the Bureau computed Mr. basis beginning with tax year 2010. The Bureau used the information reported on its corporate income tax returns for each year through 2020.

Per the Bureau's calculation, Mr. had a zero basis in at the end of 2017. Petitioners do not disagree with this for federal income tax purposes. However, for Idaho purposes Representative argued that Idaho should use a different basis computation because of the required addbacks and subtractions for bonus depreciation.

Idaho Code section 63-3022O(3) in effect at the time 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. basis in for Idaho tax purposes is the same as his basis for federal tax purposes regardless of the bonus depreciation additions and subtractions.

For tax year 2018, operations resulted in a loss. Because generated a loss, Mr. basis remained at zero and the loss is suspended. (When an S-Corp generates a loss and a shareholder has no basis, the shareholder cannot claim the loss in the loss year. The loss is suspended until the shareholder regains basis in the S-Corp.)

For tax year 2019, generated income which would have used some of the suspended loss from 2018, but because Mr. took a distribution in 2019, the distribution is applied towards the income first. Since Mr. distribution was larger than his proportionate share of income, Mr. basis for 2019 remained at zero with a suspended loss carryover to 2020.

As stated, Mr. received distributions from in 2018 and 2019. However, because Mr. had no basis for each of those years, the distributions are treated as the sale of property and included in taxable 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

Arizona. 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-Corp is considered derived from Idaho sources to the extent of the S-Corp's Idaho apportionment factor. 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. received from are considered Idaho source income and taxable by Idaho. Therefore, the Tax Commission upholds the Bureau's adjustment to income for distributions in excess of basis.

Representative stated Petitioners' 2018 QBI deduction should increase because of the added back loss from in 2018. Under the simplified calculation of the QBI deduction this is true, since qualified business income does not include losses or deductions disallowed under basis, at-risk, passive loss, or section 461(l) excess business loss limitations. In this case, when Petitioners filed their original 2018 Idaho income tax return, the return was prepared in such a manner that the loss was treated as a passive loss and not included in income. However, Petitioners amended their 2018 Idaho return to treat the loss as non-passive and included the loss in income. Petitioners' amended return also reduced Petitioners' QBI deduction. Because Petitioners should not have included the loss in their taxable income due to basis limitations, Petitioners' QBI deduction should not have been reduced for either federal or state tax purposes. But, because Petitioners are nonresidents of Idaho, they are required to prorate the QBI deduction for Idaho income tax purposes. The allowable QBI deduction for Idaho is the federal deduction multiplied by the ratio of Idaho qualified business income to total qualified business income. Because Petitioners incorrectly amended their 2018 Idaho return to include the loss from in taxable income and incorrectly included the loss in the computation of the QBI deduction, Petitioners' Idaho QBI deduction is less than what is allowable. Therefore, the Tax

Commission corrects Petitioners' 2018 QBI deduction to the amount allowable. However, for tax years 2019 and 2020 the Tax Commission found the Bureau's adjustment to Petitioners' QBI deduction correct and in accordance with Idaho law.

CONCLUSION

Mr. is a shareholder and partner in an S-Corporation and two partnerships that are located in Idaho and only do business in Idaho. 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 returns. The Idaho entities claimed bonus depreciation on their federal income tax returns. Idaho does not follow the federal bonus depreciation deductions; therefore, individuals and businesses must make the proper adjustments to their Idaho income tax return. Petitioners did not make the adjustments as required. Therefore, the Tax Commission upholds the Bureau's adjustments for bonus depreciation.

Mr. received distributions from the S-Corp, over the years of his ownership. Generally, distributions are non-taxable returns of a capital investment. However, when a shareholder has recouped all of his basis through distributions or claiming losses from the entity, distributions become taxable as a sale or exchange of property. Mr. received distributions from in 2018 and 2019 when he had no basis. Therefore, the Tax Commission upholds the Bureau's adjustment to include Mr. 2018 distribution and part of his 2019 distribution from in Petitioners' Idaho taxable income.

Petitioners claimed deductions for qualified business income. The Bureau reviewed the deductions and found that Petitioners did not prorate the deduction for the income allocable to Idaho. The Tax Commission reviewed the Bureau's adjustments and found them appropriate for the tax years 2019 and 2020. However, for tax year 2018 the Bureau prorated the deduction based on the deduction claimed on Petitioners’ amended Idaho income tax return. Petitioners’ amended return incorrectly included the loss from in Petitioners' taxable income. This limited the QBI deduction based on the income limitation. Since the Tax Commission corrected Petitioners' taxable income, Petitioners’ QBI deduction has a higher income limitation. Therefore, the Tax Commission modifies the Idaho portion of Petitioners' QBI deduction for the increase in Petitioners' 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 April 15, 2024.

THEREFORE, the modified Notice of Deficiency Determination dated March 17, 2023, directed to is AFFIRMED as MODIFIED by this decision.

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

YEAR	TAX	PENALTY	INTEREST	TOTAL
2017	$ 2,276	$114	$ 537	$ 2,927
2018	12,541	627	2,420	15,588
2019	2,074	104	298	2,476
2020	(2,034)	0	(223)	(2,257)
			TOTAL DUE	$18,734

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

DATED this ________ day of ____________________ 2024.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of ______________________________ 2024, 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.

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