

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of _____)
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) DOCKET NO. 0-305-234-944
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) Petitioner.)
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(Petitioner) protested the Notice of Deficiency Determination dated March 24, 2022, asserting additional income tax, penalty, and interest for tax years 2017 through 2020. Petitioner disagreed with the additional income the Income Tax Audit Bureau (Bureau) added to his 2018 and 2019 Idaho individual income tax returns for distributions in excess of basis from an S-Corporation (S-Corp). The Tax Commission, having reviewed the file, hereby upholds the modified Notice of Deficiency Determination dated March 17, 2023.

BACKGROUND

Petitioner 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 Petitioner’s individual income tax return and found that Petitioner did not addback and subtract the bonus depreciation as required. The Bureau reviewed Petitioner’s and _____ surrounding returns, 2017 through 2020, and found the bonus depreciation additions and subtractions were not made on those returns, and that Petitioner may not have had enough basis in _____ to exclude the distributions from his income. The Bureau reviewed _____ and _____ returns and found Petitioner did not include the bonus depreciation

additions and subtractions for those entities as well. The Bureau's review also included Petitioner's claim of the qualified business income (QBI) deduction.

Due to time constraints on Petitioner's 2018 income tax return, the statute of limitations about to expire, the Bureau computed Petitioner's basis in _____ based on the information provided on _____ corporate returns. Based on that information, the Bureau found Petitioner 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 Petitioner's 2017, 2018, 2019, and 2020 income tax returns for the bonus depreciation additions and subtractions, adjusted Petitioner's 2018 and 2019 returns for distributions in excess of basis, and properly reported Petitioner's QBI deduction. The Bureau sent Petitioner a Notice of Deficiency Determination that he protested.

Petitioner stated he disagreed with the additional income added to his 2018 and 2019 income tax returns. Petitioner stated he disagreed with the determination that the distributions from _____ were in excess of his basis in _____. And, even if he 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, California. Petitioner also stated that the Bureau's computation of his basis did not use the adjustments for Idaho income, but rather used the federal adjustments. Petitioner did not mention any disagreement with the bonus depreciation adjustments or the QBI reporting.

The Bureau acknowledged Petitioner's protest and referred the matter to the Tax Commissions Appeals Unit (Appeals) for administrative review. Appeals reviewed the matter and sent Petitioner's 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 case and found that the Bureau attributed debt basis to Petitioner in 2018. This prompted questions about loans from Petitioner 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 Petitioner in was incorrect. Appeals sent the case back to the Bureau to recalculate Petitioner's basis without any debt basis. The Bureau did the calculation which resulted in an increase to Petitioner's tax over the Bureau's previous determination. The Bureau sent Petitioner a modified Notice of Deficiency Determination and informed him that this modification was now part of his protest. Shortly thereafter, Appeals sent Petitioner a follow-up letter to its initial contact letter asking how he wanted to proceed with his protest.

Representative responded to the Bureau regarding the modification 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 Petitioner's case was sent to Appeals when Petitioner filed his 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 Petitioner has 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 Petitioner and informed him that Petitioner has 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 they wanted to proceed.

Shortly after that date, Representative sent Appeals an email with his calculations of how income/loss should be reported to Idaho. Representative agreed that Petitioner's loss is suspended for federal income tax purposes, 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 included a worksheet showing his computations and a revised 2018 Idaho individual income tax return for Petitioner. Representative also submitted a revised computation of the QBI deduction increasing it from what was claimed on Petitioner's original 2018 return. Representative asked Appeals to review his schedules 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 in this case due to the income threshold limitations, the deduction does 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 Petitioner. 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 Petitioner 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. Petitioner did not report his share of the bonus depreciation additions and subtractions on his individual income tax returns. The Bureau adjusted Petitioner’s returns for the bonus depreciation additions and subtractions. Petitioner did not protest these adjustments.

The Bureau adjusted Petitioner's 2018 and 2019 returns for distributions in excess of basis. The distributions were from [redacted] The Bureau stated that based on its calculations, Petitioner had no basis in [redacted] in 2018 and 2019; therefore, the distributions are taxable. Petitioner disagreed that the distributions are taxable by Idaho. Petitioner 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 California.

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 a zero 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 Petitioner's basis in [redacted] was filed with [redacted] 2009 return. Therefore, the Bureau computed Petitioner's basis beginning with tax year 2010. The Bureau used the information [redacted] reported on its corporate income tax returns for each year through 2020.

Per the Bureau's calculation, Petitioner had a zero basis in [redacted] at the end of 2017. Petitioner does 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, Petitioner’s 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, Petitioner’s basis remained at zero and the loss is suspended. (When an S-Corp generates a loss
and a shareholder has a zero 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 Petitioner took a distribution in 2019, the distribution is applied towards
the income first. Since Petitioner’s distribution was larger than his proportionate share of income,
Petitioner’s basis for 2019 remained at zero with a suspended loss carryover to 2020.

As stated, Petitioner received distributions from in 2018 and 2019. However,
because Petitioner 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 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-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 Petitioner 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 Petitioner's 2018 QBI deduction should increase because of the added back loss from _____ in 2018. Under the simplified calculation of the QBI deduction this would be 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. However, when the loss is added back to Petitioner's taxable income, the income threshold for the QBI deduction is exceeded and Petitioner must prorate _____ loss against _____ and _____ income. The result of this netting is the same QBI deduction originally claimed and verified by the Bureau. Therefore, the Tax Commission upholds the no change adjustment to Petitioner's QBI deduction.

CONCLUSION

Petitioner is a shareholder and partner in a 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, Petitioner must report the flow-through attributes of income, loss, deductions, and credits on his 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 return. Petitioner did not make the adjustments as required. Therefore, the Tax Commission upholds the Bureau's adjustments for bonus depreciation.

Petitioner 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. Petitioner received distributions from _____ in 2018 and 2019 when he had no basis. Therefore, the Tax Commission upholds the Bureau's

adjustment to include Petitioner's 2018 distribution and part of Petitioner's 2019 distribution from in Idaho taxable income.

Petitioner claimed a deduction for qualified business income. The Tax Commission reviewed the deduction and found that regardless of the adjustments for bonus depreciation, losses added back to income, and distributions in excess of basis, the original QBI deduction claimed is the correct amount for Idaho income tax purposes.

The Bureau added interest and penalty to Petitioner's 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.

THEREFORE, the modified Notice of Deficiency Determination dated March 17, 2023, directed to is AFFIRMED.

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

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2017	\$ 2,282	\$114	\$ 343	\$ 2,739
2018	13,254	0	1,877	15,131
2019	1,443	72	78	1,593
2020	(3,363)	0	(190)	<u>(3,553)</u>
			TOTAL	\$15,910
			Less Payment	<u>11,461</u>
			TOTAL DUE	<u>\$ 4,449</u>

Petitioner paid the Notice of Deficiency Determination dated March 24, 2022, in advance of this redetermination and of the modified Notice of Deficiency Determination dated March 17, 2023. Therefore, any additional interest is computed on the additional amounts due from the respective due dates to April 15, 2024.

An explanation of Petitioner's 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.
