

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of _____)
)
) DOCKET NO. 0-279-675-904
) 1-621-853-184
)
)
) Petitioners.) DECISION
)
 _____)

(Petitioners) protested the Notices of Deficiency Determination dated August 23, 2022, asserting additional income tax, penalty, and interest for tax years 2017 and 2018 through 2021. Petitioners disagreed with the Income Tax Audit Bureau’s (Bureau) flow-through adjustments from Idaho entities Mr. _____ owned and that the Tax Commission could make changes to tax year 2017. The Tax Commission, having reviewed the file, hereby modifies the Notice of Deficiency Determination for tax year 2017 and modifies the modified Notice of Deficiency Determination dated March 15, 2023, for tax years 2018 through 2021.

BACKGROUND

Mr. _____ is a shareholder, partner, or member of
(_____ an Idaho S-Corp; (_____ an Idaho partnership;
 (_____ an Idaho partnership; (_____ an Idaho limited
liability company; and (_____ an Idaho limited liability company.

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 return and found that they did not addback the bonus depreciation as required. The Bureau reviewed Petitioners’ and _____ surrounding

returns, 2017 through 2021, 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 Petitioners' income. The Bureau also 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 revealed that Petitioners did not avail themselves of the qualified business income (QBI) deduction for tax years 2018 through 2020 and incorrectly computed it for tax year 2021. In addition, the Bureau found that Petitioners did not file an Idaho income tax return for tax year 2017.

The Bureau asked Petitioners to provide their calculations of basis in _____ and to provide copies of all loan agreements with _____. The Bureau asked Petitioners to provide a copy of the schedule showing the breakdown of their pass-through income and to provide a copy of their 2017 Idaho income tax return.

Petitioners provided a copy of their 2017 Idaho income tax return but did not provide any loan documents or basis computations. The Bureau found a basis computation attached to Petitioners' 2020 federal income tax return and one attached to _____ 2009 corporate income tax return. The Bureau used that information and the information provided on _____ corporate returns to determine Mr. _____ basis in _____ for 2017, 2018, and 2019. What the Bureau found was that Mr. _____ basis was insufficient for all the distributions to be treated as a return of capital (non-taxable). Therefore, the Bureau adjusted Petitioners' 2017, 2018, and 2019 returns for distributions in excess of basis.

Petitioners provided information to show how they determined the income sourced to Idaho from Mr. _____ pass-through entities. The Bureau reviewed that information and found that it

did not match what was reported on Petitioners' income tax returns. Therefore, the Bureau adjusted Petitioners' income and/or losses flowing from Mr. [redacted] pass-through entities.

The Bureau also found that Petitioners did not make the appropriate additions and subtractions for bonus depreciation. Therefore, the Bureau adjusted Petitioners' 2017, 2018, 2019, 2020, and 2021 income tax returns to account for bonus depreciation. The Bureau also adjusted Petitioners' QBI deduction and their health insurance premiums deduction because of the adjustments that changed their overall income.

The Bureau sent Petitioners two Notices of Deficiency Determination, one for tax year 2017 and one for tax years 2018 through 2021, that they protested. Petitioners stated they disagreed with all the adjustments the Bureau made. Petitioners stated they included the bonus depreciation additions and subtractions and had provided reconciliation schedules showing the reconciliation for federal to state depreciation. Petitioners stated they had previously provided a basis computation for 2018 and 2019 and believed it to be correct. Petitioners also contest Idaho's ability to tax any excess basis distributions as that defers to the taxpayer's state of residence. Petitioners stated the Bureau's QBI adjustment was incorrect because it should be a subtraction from Idaho income. Petitioners asked that their case be submitted to Appeals.

The Bureau acknowledged Petitioners' protest and referred the matter to the Tax Commission's 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' representative contacted Appeals and asked to have their case put on hold pending the outcome of another case with the same issue that was already in Appeals. Appeals agreed.

While waiting for the other case to be decided, Appeals noted that the Bureau attributed debt basis to Mr. [redacted] in [redacted]. However, after a review of [redacted] corporate income tax return, Appeals found no record of loans from shareholders on [redacted] balance sheet. Based on this fact, Appeals determined the basis calculation the Bureau made for Mr. [redacted] in [redacted] was incorrect. Appeals sent the case back to the Bureau to recalculate Mr. [redacted]

basis without any debt basis. The Bureau did the calculation which resulted in an increase to the total of Petitioners' 2018 through 2021 tax based on the Bureau's previous determinations. The Bureau sent Petitioners a modified Notice of Deficiency Determination for the tax years 2018 through 2021 and informed them that this modification was now part of their protest.

Petitioners' representative responded to the modification stating that they provided a detailed explanation of why the original audit adjustments were inaccurate and erroneous, and no one has yet to address that response. Representative stated the Tax Commission's representatives continue to miss the obvious in the computation of Mr. [redacted] basis in [redacted]

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 [redacted]

loss shown on schedule K-1. Representative stated the auditor continues to ignore IRC section 465 and makes 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, Petitioners' representative stated all bonus depreciation was properly claimed in 2018. Representative stated there are some variances in the [redacted]

depreciation adjustments for both 2019 and 2020, but overall, in a recap of all the adjustments, there is an overstatement of Idaho income. The Tax Commission acknowledged Representative's response and informed them again that this modification was now part of their original protest.

The Tax Commission decided the other similar case, so Appeals contacted Petitioners' representative and asked him how he wanted to proceed with Petitioners' case. Representative requested a telephone hearing which was held on July 19, 2023. In attendance at the hearing were

CPA, Petitioners' representative (Representative), and hearing the case were Commissioner and Tax Appeals Specialist.

During the hearing Mr. basis in was the major topic of discussion. Representative questioned the change to the original audit of Mr. debt basis.

Representative stated Petitioners were never given the opportunity to substantiate Mr. debt basis. Appeals explained the reason for the change and told Representative that if Petitioners could provide documentation of shareholder loans, the Tax Commission would include those loans as part of Mr. basis.

Representative did not understand why Idaho was not allowing the bonus depreciation addback and subtraction in the computation of Mr. basis. Representative stated it is only logical since Idaho requires the addback of bonus depreciation. Appeals explained that Idaho law used the same basis calculation as prescribed in the IRC, which includes the at-risk rules but makes no provision for bonus depreciation. Therefore, no adjustments to basis can be made for the addback of bonus depreciation.

Representative stated the bonus depreciation is an individual deduction and Petitioners did not claim any bonus depreciation. Appeals pointed out that the bonus depreciation was claimed by

Mr. [REDACTED] pass-through entities and as a result, the bonus depreciation passed through to him in the income or loss Petitioners reported on their individual income tax returns.

By the end of the basis discussion, Representative seemed to concede that Mr. [REDACTED] did not have any basis in [REDACTED] based on the information available. Nevertheless, Representative stated he would go through his information and check with Petitioners for any information on loans made to

Representative stated Petitioners incurred expenses in the management of the Idaho entities that were incurred outside of the entities' operations. Representative stated Petitioners reported those expenses separately as unreimbursed partner or shareholder expenses, and some were reported on schedule C as Partnership management. Representative stated a portion of those expenses should be allowed on Petitioners' Idaho returns since they were directly related to the management of Mr. [REDACTED] Idaho entities. Appeals asked Representative to provide a schedule showing an allocation of the expenses to each entity.

In regard to tax year 2017, Representative stated Petitioners' return was electronically filed. Representative stated that generally they get confirmation from the states when they electronically file, but he did not get one from Idaho for 2017. Representative stated he would look to see what he could provide to show Petitioners timely filed their 2017 Idaho income tax return.

Appeals provided information regarding Petitioners' Idaho filing history stating that Petitioners filed paper income tax returns with Idaho up until 2019 when they began filing electronically. Appeals stated both the year before and the year after 2017 were submitted on paper. Appeals stated it would consider any information Representative might have to show Petitioners' 2017 return was timely filed.

Shortly after the hearing Representative submitted a schedule showing an allocation of management expenses for Mr. _____ pass-through entities. Representative also provided a copy of the confirmation he received for electronically filing Petitioners' 2017 federal income tax return. Appeals reviewed the information and commented back to Representative. Appeals stated Representative's allocation schedule was a reasonable allocation but that it included amounts already reported on Petitioners' Idaho returns. As for the 2017 information, Appeals stated that after talking with the Tax Commission processing division, the chances of Petitioners filing an electronic return and not getting a confirmation was extremely rare, and the evidence of Petitioners' track record of filing paper returns until 2019 would be difficult to overcome. Representative responded that California's and Arizona's returns were filed at the same time, and he got confirmation from them. Representative stated he did not have anything further to show 2017 was timely filed.

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/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 [redacted] Representative stated depreciation was only claimed on the return that did not exceed Mr. [redacted] 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.

[redacted] flow-through entities, [redacted] and [redacted]

Petitioners incorrectly reported the bonus depreciation additions and subtractions; therefore, the Tax Commission finds the adjustments made for tax years 2017, 2018, 2019, 2020, and 2021 for bonus depreciation should stand.

Petitioners disagreed with the Bureau's determination that the 2017, 2018, and 2019 distributions from [redacted] are taxable. The Bureau stated that based on its calculations, the 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 earliest 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 2021.

For tax year 2017, Mr. [REDACTED] basis in [REDACTED] was \$0 with no suspended loss carryover. (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 \$77,704. Mr. [REDACTED] basis remained at \$0 but he now has a suspended loss carryover of \$77,704. 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 \$46,641. 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. 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. contributed to, or generated income giving him a basis of \$489,596, Mr. at-risk amount. From 2010 to 2016, operations yielded income and losses to Mr. and Mr. took distributions or returns of his capital (his investment) that left him with no basis in at the end of 2016. This zero-basis continued through 2017. Therefore, Mr. basis in at the beginning of 2018 was \$0 and because of IRC section 465 at-risk limitations and the rules for computing basis, IRC section 1367, the loss generated by for tax year 2018, cannot be claimed by Petitioners on their 2018 individual income tax return. Therefore, the Tax Commission upholds the Bureau's adjustment to Petitioners' pass-through income.

Mr. received distributions from in each of the years under review. Since it has already been established that Mr. had a zero-tax basis, the distributions are treated as a sale or exchange of property, the gain from which is income to Mr. 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. 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, in excess of his basis in [redacted] are considered Idaho source income and taxable by Idaho. For tax years 2017 and 2019, [redacted] generated income which created basis for Mr. [redacted]. For those years, the distributions Mr. [redacted] received were offset by the income creating basis and the balance of the distributions are added to Petitioners' income. As for tax years 2020 and 2021, [redacted] generated more income than the distributions Mr. [redacted] received; therefore, no additional income is added to those years. For 2018, [redacted] generated a loss and Mr. [redacted] had no basis; therefore, all the distribution Mr. [redacted] received is added to Petitioners' income.

Representative 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) 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. [redacted] basis in [redacted] for Idaho tax purposes is the same as his basis for federal tax purposes. The Tax Commission upholds the Bureau's adjustments for distributions in excess of basis.

The Bureau adjusted the return Petitioners provided a copy of for tax year 2017. Petitioners argued that their 2017 return cannot be adjusted because the statute of limitations for that year is closed. However, Idaho Code section 63-3068 states that a notice of deficiency can be issued within three (3) years of either the due date of the return or the date the return was filed, whichever is later. Petitioners' 2017 Idaho income tax return had a due date of April 16, 2018. The Tax Commission did not receive Petitioners' 2017 Idaho income tax return until they provided the copy on July 6, 2022.

Petitioners argued they timely filed their 2017 Idaho return. Petitioners stated it was electronically filed at the same time as their federal return and their other states' income tax returns. When asked if they received confirmation from Idaho of the filing Petitioners stated they did not. Petitioners stated they did receive confirmation of their federal and other states filings and provided a copy of the federal confirmation.

The Tax Commission reviewed Petitioners' filing history and found that Petitioners attempted to file electronically for tax year 2012 but that return was rejected, and a notice was sent to Petitioners. Petitioners subsequently filed a paper return. The Tax Commission has no record of any other attempts or actual electronic filing until tax year 2019 wherein Petitioners successfully electronically filed and received an acknowledgement of receipt. All tax years between 2012 and 2016 were timely filed but filed on paper. Tax year 2018 was also filed on paper but was filed late.

Based on Petitioners' filing history and the fact that Petitioners had nothing to show they timely filed their 2017 Idaho income tax return, the Tax Commission finds Petitioners' 2017 Idaho income tax return is within the statute of limitations for making adjustments. Therefore, the Tax Commission upholds the Bureau's adjustments made to Petitioners' 2017 Idaho income tax return.

Representative contested the Tax Commission's ability to open other issues or to increase the audit results. During the appeal process, Appeals found that the Bureau attributed debt basis to Mr. [redacted] that did not appear on [redacted] returns. The Bureau asked Petitioners for loan documents in its initial request. Petitioners provided no such documentation, nevertheless, the Bureau attributed debt basis to Mr. [redacted].

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 _____ without the debt basis. Because Petitioners did not meet their burden of establishing a basis in _____ the Tax Commission finds it appropriate that the Bureau recomputed Mr. _____ basis without the debt basis that was previously attributed to him.

During the appeal, Petitioners were given the opportunity to provide documentation substantiating a debt basis for Mr. _____. Petitioners provided no additional information to support loans from Mr. _____ to _____. Therefore, the Tax Commission upholds the modification removing the debt basis attributed to Mr. _____.

Finally, Representative argued that Petitioners incurred expenses outside the pass-through entities that were reported on their federal income tax returns but were not included on their Idaho income tax returns. Representative submitted a schedule showing the total expenses incurred and an allocation of the expenses to Petitioners' Idaho pass-through entities. The Tax Commission reviewed the schedule and found that although the allocation was very rudimentary, it was a reasonable approximation of the expenses attributed to each Idaho entity. However, for some of the years the Tax Commission found that the expenses scheduled as unreimbursed partner expenses and unreimbursed shareholder expenses were already reported on Petitioners' Idaho returns. Therefore, the Tax Commission subtracted those expenses and reallocated the remaining expenses in accordance with Representative's methodology.

CONCLUSION

Mr. _____ is a shareholder, a partner, and a member in a S-Corporation, two partnerships, and two limited liability companies that are located in Idaho and only do business in Idaho. The Idaho S-corporation and partnerships 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 his ownership. Generally, distributions are non-taxable returns of a capital investment. However, when a shareholder has recouped all of their investment (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 his basis. Petitioners did not establish a basis other than the amount determined by the Bureau, which for 2018 was zero and for 2017 and 2019 reduced to zero after accounting for part of Mr. [redacted] distributions. Therefore, the Tax Commission upholds the Bureau's adjustment to include Mr. [redacted] 2018 distribution from [redacted] in Idaho taxable income and a portion of his 2017 and 2019 distributions in Idaho taxable income.

Petitioners also failed to file an Idaho income tax return for tax year 2017. When Petitioners submitted a copy of their 2017 return, the Tax Commission deemed it filed as of the date received. Because of Petitioners' late filing of their 2017 return, the Tax Commission finds the adjustments the Bureau made to the return within the statute of limitations and therefore upholds those adjustments.

The Tax Commission further finds that Petitioners did not claim outside expenses attributed to the Idaho pass-through entities. Therefore, the Tax Commission adds an allocation of those expenses to Petitioners' Idaho returns and modifies the Notices of Deficiency Determination accordingly.

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 February 10, 2024.

THEREFORE, the Notices of Deficiency Determination dated August 23, 2022 and March 15, 2023, directed to _____ are AFFIRMED as MODIFIED by this decision.

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	\$1,731	\$433	\$391	\$2,555
2018	8,199	1,393	1,495	11,087
2019	(1,102)	0	(141)	(1,243)
2020	(4,832)	0	(480)	(5,312)
2021	(920)	0	(71)	<u>(991)</u>
			TOTAL DUE	\$6,096

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.
