

remodel of its (store. The Bureau allowed Petitioner additional time to obtain the documentation needed for the soft costs, but after several months with no additional documentation provided, the Bureau proceeded with finalizing the audit. Because Petitioner did not document the soft costs, the Bureau disallowed them. This disallowance affected Petitioner's depreciation and investment tax credit. The Bureau also determined Petitioner improperly classified some of the acquired or constructed depreciable property. The Bureau corrected the class lives of the property which changed Petitioner's depreciation expense and the bonus depreciation addback. As for Petitioner's Other Subtraction, the Bureau found that Petitioner claimed a subtraction for the wages it was required to addback for federal tax purposes in order to claim the federal work opportunity credit. The Bureau disallowed the subtraction because Idaho does not provide for a subtraction in the case of the addback of wages for the work opportunity credit. The Bureau corrected Petitioner's returns for these adjustments and sent it a Notice of Deficiency Determination.

Petitioner protested the Bureau's determination disagreeing with all the adjustments the Bureau made. Petitioner stated the proposed adjustments to the depreciation expense relate to the remodel of an existing store located in Idaho. Petitioner stated the Bureau did not allow the allocation of soft costs for the demolition, document and planning, and general condition costs that were all related to the construction remodel project. Petitioner stated the Bureau disallowed the soft costs due to lack of documentation. Petitioner stated it would provide the documentation, from the contractor, when it is received. Petitioner stated the construction contract included the removal, redesign and reinstallation of new and existing equipment, equipment, and and Petitioner stated the planning, design, and construction oversight on these important areas of the

store's structure should be allocated the costs related to their implementation i.e., the soft costs. Petitioner stated it properly allocated the soft costs to the assets that they related to in the remodel project. Petitioner stated its allocation should be accepted as an accurate reflection of all project remodel costs.

Petitioner stated that it disagreed with the Bureau's changes to asset class lives as a result of the remodel project. Petitioner stated the ceramic tile, corner guards, fireplace, and front piers and masonry were all decorative and nonstructural. Petitioner stated each of them could be removed without causing harm to the structure of the building; therefore, the appropriate class-life is 5-year property, not 39-year property. Petitioner stated the gutters and downpipes should not be classified as a 39-year property since they are not part of the building component and are routinely replaced as part of roof maintenance. Lastly, Petitioner stated that it elected the de minimis safe harbor election of Treasury Regulation section 1.263(a)-1 (f) to deduct the cost of the toilet accessories rather than depreciating them. Therefore, the toilet accessories should be classified as 5-year property or expensed rather than capitalized as 39-year property.

Petitioner stated that because of the adjustments the Bureau made in disallowing the soft costs and changing the class lives of certain property, the depreciation expense, including the addition for bonus depreciation, was adjusted. Petitioner stated it does not agree with the asset class changes or the soft cost allocation and that the depreciation reported on its 2018 tax return is correct.

Petitioner disagreed with the Bureau's disallowance of the Other Subtraction claimed on its Idaho returns. Petitioner stated the Other Subtraction was for wages it paid employees during the tax years which are a federal tax deduction under Internal Revenue Code (IRC) section 162(a)(1). Petitioner stated because a portion of these wages also qualified for the federal work

opportunity credit and could not be deducted as wage expense on its federal return, a subtraction from Idaho income for the amount of federal tax credit is required to avoid a "double benefit". Without the subtraction, Petitioner receives no tax benefit in Idaho for the wages paid.

Lastly, Petitioner disagreed with the Bureau's adjustment to the Idaho investment tax credit (ITC). Petitioner stated the changes to ITC are a result of the adjustments the Bureau made to the soft costs allocation as well as to the asset class lives. Since Petitioner disputes those changes, the change in ITC is also in dispute. Petitioner stated that it has correctly reported all additions as well as the resulting ITC for all tax years.

The Bureau acknowledged Petitioner's protest and referred the matter to the Tax Commission's Appeals Unit (Appeals). Appeals sent Petitioner's representative (Representative) a letter asking how they wanted to proceed with their protest. Representative responded stating he would consult with his client and inform the Tax Commission of its decision before the due date in the letter. Just after the due date, Appeals received a letter from Representative stating that they were getting information from the contractor on the remodel of the store. Representative stated they would provide additional information on the allocation of soft costs, asset class lives, ITC, and the federal work opportunity credit. Representative asked that they be given until April 29, 2022, to provide the information.

Appeals allowed Representative the time requested and substantially more, but no information was received. Appeals emailed Representative asking about the documentation and when it could be expected. Representative stated they would send the information the following Monday. A few days after that Monday, Appeals emailed Representative asking if the information had been sent. Representative did not respond. Appeals sent a follow-up email asking if Representative planned on sending more information and when it can be expected. Several days

later Representative responded that the information would be to the Tax Commission by December 16, 2022.

The Tax Commission did receive Representative's response and a copy of an invoice covering part of the allocated soft costs. Representative's response restated Petitioner's original protest with some additional facts.

Representative stated the soft cost allocation was for the services of the project manager on the remodel. Representative stated the costs were appropriately allocated to all aspects of the project. Representative stated because the soft costs were related to the entire project, including the purchase, design, and arrangement of equipment, they were allocated proportionally to the equipment and building to reflect the project cost.

Representative stated the asset class lives listed in their previous response were appropriately categorized as tangible personal property and not part of the structural component of the building. Representative stated the costs related to ceramic tile, fireplace, and decorative front piers and masonry clearly fall under the "decor" classification that is used in the Internal Revenue Service Cost Segregation Guide to Restaurant and Gaming Facilities. Representative stated that the soft costs were properly allocated, and the asset class life appropriately categorized; therefore, the depreciation expense claimed was accurately reported.

Regarding the Other Subtraction, Representative stated they subtracted the wages eligible for the work opportunity credit because the wages were incurred on Petitioner's Idaho tax return, and since Idaho does not provide a similar adjustment to Idaho income as allowed for federal reporting purposes, they subtracted the wages to receive benefit from the costs associated with their Idaho operations.

Appeals reviewed the documentation Representative provided and found that the documentation was for only about half of the soft costs Petitioner claimed. Appeals contacted Representative and asked if they were planning on submitting the remaining documentation for the soft costs. Representative stated they were still working on getting the other documentation and would send it as soon as they get it. A couple of months later Representative provided the remaining documentation.

Appeals reviewed the documentation provided and had the Bureau make the appropriate revisions to its audit allowing all the documented soft costs and reallocating the soft costs to the project assets. The revision changed the depreciation adjustments and the ITC adjustment. The Other Subtraction adjustments remained the same.

Appeals sent the revised audit report to Representative with additional information regarding the asset classes in relation to the cost segregation analysis. Appeals asked Representative to review the information and contact it for any other issues that needed to be discussed. Representative did not respond. Appeals sent a follow-up to Representative letting them know that if they did not contact the Tax Commission, the Tax Commission would begin its decision making process. Representative did not respond, so the Tax Commission decided the matter based on the information available.

LAW AND ANALYSIS

In 2018, Petitioner remodeled its store. The Bureau reviewed the costs associated with the remodel and made several adjustments relating to the depreciation expense, the Idaho bonus depreciation addback and the Idaho investment tax credit claimed on the remodel. The Bureau determined Petitioner improperly allocated the soft costs relating to the remodel contract to assets other than those in the remodel. The Bureau reallocated the costs to the assets

directly included in the remodel contract. The Bureau only allocated the portion of the soft costs that Petitioner substantiated.

The Bureau determined Petitioner did not correctly classify some of the resulting assets of the remodel. Therefore, the Bureau reclassified some 5-year property to 39-year property. The assets determined to be part of the building and needing reclassification included a fireplace, ceramic wall tile, decorative masonry and front piers, gutters and downpipes, corner guards, overhead doors, framing, and a pass-through window.

The Bureau recomputed the depreciation based on the reclassification of the assets and the reallocation of the soft costs. The Bureau reduced the bonus depreciation addback because of changes to depreciation. The Bureau also corrected the ITC because of the reclassification of property, the reallocation of the soft costs, and for credit claimed on real property improvements.

Petitioner claimed an Other Subtraction to compensate for the wages that were required to be added back to claim the federal work opportunity credit. As it did in the prior years, the Bureau disallowed the subtraction because Idaho does not have a provision in state law to allow a subtraction for the added wages.

IRC section 263A provides that any property produced by a taxpayer for use in a trade or business shall be capitalized. Allocable costs to include the direct costs of the property and the property's proper share of those indirect costs, part or all of which are allocable to the property. Construction projects such as Petitioner's remodel of its store require the capitalization of the property produced, refurbished, or replaced.

Petitioner incurred direct costs associated with the properties and separated them accordingly. However, as Petitioner argued, the remodel project included costs for demolition, document and planning, and construction oversight; indirect costs that needed to be allocated to

the properties. Petitioner initially could not document all its indirect costs, so the Bureau disallowed the undocumented costs and reallocated the costs. But during the appeal process, Petitioner was able to get the documentation, so the Tax Commission modified the property values accordingly.

The Bureau changed some of the property class lives, determining that some of the property classified as IRC section 1245 property (tangible personal property) should be IRC section 1250 property (real property). Petitioner on the other hand believes its classification of the properties is correct stating that the Bureau's changes were to property that qualifies as "décor". Petitioner referenced the Internal Revenue Service Cost Segregation Guide as support for classifying the property as section 1245 property.

The Tax Commission reviewed the same guide but came to a different conclusion. Cost segregation is the process of allocating costs to assets and determining the asset class. Generally, assets are either section 1245 property, which have a short cost recovery period between 5 or 7 years, or are section 1250 property, which have a long cost recovery period between 39, 31.5 or 15 years. The Internal Revenue Service Cost Segregation Guide provides a nonexclusive matrix of possible properties and their recovery periods (recovery period = class life). When the Tax Commission reviewed the guide it found the Bureau's determinations regarding the ceramic tile, the corner guards, the toilet accessories, the fireplace, the front piers and masonry, and gutters and downpipes all in line with the guide.

Petitioner argued its classification of the assets was correct. However, other than its statements, Petitioner provided nothing evidentiary to show the assets fall outside the IRS guidelines for cost segregation. Because Petitioner failed to establish class lives other than what is

recommended in the guide, the Tax Commission upholds the Bureau's reclassification of the asset class lives.

Idaho Code section 63-3029B provides a credit for capital investment, commonly called the investment tax credit (ITC). The ITC is available on qualified investments acquired, constructed, reconstructed, erected, or placed into service after December 31, 1981, that have a situs in Idaho. Qualified investments are defined in Internal Revenue Code sections 46(c), 46(f), and 48 of the Internal Revenue Code as they existed in the Internal Revenue Code of 1986 prior to November 5, 1990. Included in the definition is tangible personal property used in a trade or business, property used in manufacturing, and depreciable property. Qualified investments do not include buildings and their structural components.

The Bureau, in its reclassification of certain assets, found that Petitioner treated real property assets as tangible personal property assets. The Bureau also found that Petitioner made an allocation of soft costs for the building remodel to assets not part of the remodel contract. This affected the assets' total cost in determining the qualified investment for ITC purposes. After Petitioner documented all the soft costs on the remodel, the Bureau modified its allocation of the soft costs thereby increasing the amount of qualified investment.

Petitioner's argument regarding the ITC is that its asset life classification is correct, and the ITC claimed should be allowed. However, as discussed above, Petitioner provided no support for its classification for depreciation purposes and that same classification is used in determining qualified investments for the ITC. Therefore, the Tax Commission upholds the Bureau's adjustment of asset classification for the ITC.

Petitioner claimed an Other Subtraction on its Idaho returns to compensate for the wages added back when claiming the federal work opportunity tax credit. The Bureau disallowed the

Other Subtraction on the basis that Idaho law does not make provision to subtract the added back wages. Petitioner argued that subtracting the wages allows it to receive benefit for the wages. Petitioner stated the subtraction from Idaho income is solely to avoid a "double benefit". Since Idaho does not have a similar employment related tax credit, there is no tax benefit for Petitioner with Idaho if a subtraction is not allowed. Absent such a subtraction, Petitioner will never receive a state benefit for those employment expenses. Petitioner also argued the justification for the adjustment cited by the Bureau is not applicable. Petitioner stated the case cited does not involve federal employment credits.

The case cited by the Bureau, *Potlatch Corporation and Extended Systems Inc. vs Idaho State Tax Commission*, 128 Idaho 387, 913 P.2d 1157 (1996), was decided on the principle that if Idaho law does not provide for a specific deduction or subtraction from income, no deduction or subtraction can be made on the Idaho income tax return. Petitioner stated the case does not apply because it does not deal with federal employment credits. However, if one were to substitute the applicable Internal Revenue Code sections for the work opportunity credit in the following excerpt, the principle applied by the Idaho Supreme Court is the same.

While I.R.C. § 404 allowed Potlatch a deduction for ESOP contributions, I.R.C. § 44G(c)(5) disallowed this deduction to the extent of any credit taken for the same contributions. These are both portions of Chapter 1 of the Internal Revenue Code. Therefore, the deductions for ESOP contributions claimed by Potlatch were not “allowed” by Chapter 1 and were not subtracted from federal gross income in arriving at federal taxable income, as “defined” in I.R.C. § 63. Idaho taxable income means the same as federal taxable income, subject to adjustment as provided in the subsections of I.C. § 63–3022. There is no subsection of I.C. § 63–3022 that would adjust taxable income by allowing the ESOP contributions as deductions.

Potlatch Corporation and Extended Systems Inc. vs Idaho State Tax Commission, Ibid.

Therefore, the Tax Commission agrees with the Bureau’s adjustment disallowing Petitioner’s Other Subtraction for the federal work opportunity credit.

CONCLUSION

Petitioner filed its Idaho S-Corp income tax returns for tax years 2017 and 2018 with a similar Idaho subtraction that the Tax Commission disallowed on its three previous years' income tax returns. The Bureau contacted Petitioner about the Other Subtraction and expanded its inquiry to include Petitioner's ITC. During the examination, the Bureau determined that Petitioner did not properly classify some of its capitalized costs on a remodel project. Petitioner also failed to substantiate some of its indirect costs related to the remodel. The Bureau reclassified Petitioner's assets and recomputed the allocation of indirect costs based on the costs Petitioner substantiated. Based on the reclassification and reallocation, the Bureau adjusted Petitioner's depreciation, bonus depreciation addback, and ITC. The Bureau also disallowed Petitioner's Other Subtraction because Petitioner was claiming a subtraction for the federal work opportunity credit.

Petitioner protested and provided additional documentation for the indirect costs but did not provide any additional support for the classifications of the assets or the Other Subtraction. The Tax Commission allowed the additional indirect costs reallocating them to the remodel assets, which changed Petitioner's depreciation expense, bonus depreciation addback, and ITC. However, the Tax Commission did not change the Bureau's assets classifications or the disallowed Other Subtraction.

THEREFORE, the Notice of Deficiency Determination dated June 30, 2021, and directed to _____ is AFFIRMED as MODIFIED by this decision.

Since Petitioner is a pass-through entity, the additional tax owed is passed down to its shareholders. Therefore, no demand or order for payment is necessary.

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.

COPY SENT TO: