

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 14198
[Redacted],)	
)	DECISION
Petitioners.)	
_____)	

On September 8, 1999, the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination to [Redacted] (petitioners), proposing additional income tax, penalty, and interest for the taxable years 1995 and 1996, in the total amount of \$94,665. The petitioners filed a timely protest and petition for redetermination. A hearing was held on August 23, 2000. The Tax Commission, having reviewed the file, hereby issues its decision.

The issue before the Tax Commission is whether or not some of the gain being passed through from [Redacted] (hereafter “Old S”), an Idaho S corporation, to the petitioners should be treated as capital gain or as ordinary income.

FACTS

[Redacted] (hereafter “husband”) held a one-third interest in Old S. Old S was doing business as [Redacted]. Old S was formed in 1983 and has always been an S corporation. Old S owned and operated an Idaho [Redacted], Idaho.

In December of 1996, the husband bought out the other shareholders of Old S and became the sole shareholder of the corporation.

Immediately after the acquisition of the other shareholders’ stock in Old S, the husband liquidated Old S and the husband, as part of the liquidating distribution, received all of Old S’s property. The husband immediately contributed the majority of the intangible and tangible personal property he received in the liquidating distribution to [Redacted], (hereafter “New S”), an Idaho S corporation formed on November 18, 1996. The husband is the sole shareholder of

New S. The husband did not contribute the real property received in the liquidating distribution to New S. Instead the husband retained ownership of the real property and is leasing the real property to New S.

[Redacted]. The \$75,471 net capital gain was made up of various capital losses and capital gains being offset against one another. Included in the calculation of the petitioners' net capital gain was \$885,780 of gain, which had been passed through from Old S to the petitioners. Federal law required Old S to recognize gain or loss on property distributed in complete liquidation as if Old S had sold the property to its shareholder at fair market value. The \$885,780 was part of the overall gain Old S was required to recognize.

The Tax Commission's audit staff (hereafter "staff") disagreed with the characterization of the \$885,780 as capital gain. It is the staff's position that the gain should have been treated as ordinary income in accordance with IRC § 1239. The net result would be that the petitioners' 1996 Idaho taxable income is adjusted as follows:¹

Increased by capital gain treated as ordinary income	\$885,780
Additional capital loss deduction allowed	<u>3,000</u>
Net Increase in petitioners' Idaho Taxable Income	\$882,780

LAW AND ANALYSIS

Subchapter S of the Internal Revenue Code governs the tax treatment of S Corporations and their shareholders. Subchapter S contains §§ 1361 through 1379 of the IRC.² IRC § 1371 states that "except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C will apply to an S corporation and its shareholders." Since,

¹ The Notice of Deficiency Determination reflects an increase in Idaho Taxable Income of \$883,042, which is \$262 higher than the increase in Idaho Taxable Income per this decision. The \$262 difference is the result of the petitioners' net short-term capital gain not being included in the staff's calculation.

² All Internal Revenue Code section references hereafter and unless otherwise indicated refer to the 1954 Internal Revenue Code, as amended effective January 1, 1996.

subchapter S does not address the tax impacts of the complete liquidation of an S corporation, subchapter C and/or other provisions of Title A of the Internal Revenue Code will apply.

SUBCHAPTER C

Subchapter C of the Internal Revenue Code governs corporate distributions and adjustments. Subchapter C contains IRC §§ 301 through 385. IRC §§ 331 through 336 govern corporate liquidations including the tax implications to the liquidating corporation as well as the tax implications to the shareholders.

The gain or loss of a corporate liquidation to the shareholder is governed by IRC § 331.

IRC § 331(a) reads as follows:

(a) Distributions in complete liquidation treated as exchanges. – Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

Thus, the husband must determine his gain or loss on his stock in Old S as if he had received full payment in exchange for his Old S stock. The staff and the petitioners are in agreement as to the amount of loss recognized by the husband on his Old S stock, therefore, no additional discussion on IRC § 331 is required.

The gain or loss to the liquidating corporation on property distributed in a complete liquidation is governed by IRC § 336. IRC § 336(a), provides as follows:

(a) General rule. – Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

Unless one of the exceptions provided for in IRC §§ 336 and 337 applies, Old S (the liquidating corporation) must recognize gain or loss on property distributed in a complete liquidation as if the property were sold to the husband (distributee) at the property's fair market value. The staff and the petitioners are in agreement as to the total amount of gain recognized by Old S. Neither

party is claiming that any of the exceptions found in IRC §§ 336 and 337 should apply.

The staff and the petitioners disagree with respect to the character of a substantial portion of the gain recognized by Old S and passed through to the petitioners. Since Old S is an S corporation, the gain or loss recognized by Old S was passed through to the shareholder (husband) in accordance with IRC § 1366. The following is a listing of income and loss items recognized by Old S in 1996:

The staff maintains that \$885,780 of the gain due to the liquidation of Old S should have

Income and gains passed through from Old S to the husband:

Net Long Term Capital Gain:

Intangibles and Contracts (part of IRC § 336 calculation)	\$ 89,378	
Installment Sale (not part of IRC § 336 calculation)	<u>12,475</u>	
Subtotal		\$ 101,853

IRC § 1231 Net Gain:

Building (part of IRC § 336 calculation)	\$ 885,780	
Land (part of IRC § 336 calculation)	<u>245,217</u>	
Subtotal		<u>1,130,997</u>

Net Capital Gain

\$ 1,232,850

Ordinary and Other Income Items:

Tangible Personal Property (part of IRC § 336 calculation (and treated as ordinary income per IRC § 1245)	\$ 148,414	
Interest Income (not part of IRC § 336 calculation)	1,791	
Operating income/(loss) (not part of IRC § 336 calculation)	<u>(12,810)</u>	
Subtotal		<u>137,395</u>

Total Income Passed Through the Husband per Old S's 1041 K-1

\$ 1,370,245

been treated by Old S as ordinary income in accordance with IRC § 1239 and Treas. Reg.

1.1239-1.³ The \$885,780 is that portion of the gain attributable to the depreciable real property ([Redacted]) that the husband received as part of the liquidating distribution.

³ The regulations under IRC § 1239 do not reflect the changes made to IRC § 1239(c)(1) by the Tax Reform Act of 1986, which, among other changes, substituted "more than 50 percent of the value" for "80 percent or more in value" for purposes of defining a "controlled entity."

INTERNAL REVENUE CODE § 1239

The applicable provisions of IRC § 1239 are as follows:

§ 1239. Gain from sale of depreciable property between certain related taxpayers

(a) Treatment of gain as ordinary income.--In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167.

(b) Related persons.--For purposes of subsection (a), the term "related persons" means--

(1) a person and all entities which are controlled entities with respect to such person,

...

(c) Controlled entity defined.--

(1) **General rule.**--For purposes of this section, the term "controlled entity" means, with respect to any person--

(A) a corporation more than 50 percent of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person,

(B) a partnership more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person, and

(C) any entity which is a related person to such person under paragraph (3), (10), (11), or (12) of section 267(b).

...

In order for IRC § 1239 to apply, the parties involved must be "related persons." IRC § 1239(b) states that related persons are "a person and all entities which are controlled entities with respect to such person." The petitioners' representative has acknowledged that the husband owned 100% of Old S just prior to Old S's liquidation. However, the representative argues that since the husband only owned 100% of the stock for just that instant between the purchase of the stock and the immediate dissolution of Old S, the Tax Commission should ignore that ownership

relationship and instead focus on the fact that the husband only owned 33 1/3% of Old S since its inception.

Nonetheless, the instant that the husband became a 100% shareholder in Old S, Old S became a “controlled entity” as that term is defined under IRC § 1239(c)(1). Included in the definition of a controlled entity under IRC § 1239(c)(1) is, with respect to any person, “a corporation more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person.” Therefore, the Tax Commission finds that the “related parties” test under IRC § 1239(b)(1) and the “controlled entity” test under IRC § 1239(c)(1) apply.

IRC § 1239(a) is triggered upon the occurrence of “a sale or exchange of property, directly or indirectly, between related persons” and the property received in the liquidation is “in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167.” With respect to the latter, the building that the husband received from Old S (transferor) is clearly of a character that is subject to the allowance for depreciation in the hands of the husband (transferee). The petitioners do not dispute this fact. With respect to a sale or exchange having occurred, the representative maintains that “[t]he specific text of IRC Section 1239(a) refers to a sale or exchange of property, not a liquidating distribution of property.”

Letter of protest dated November 3, 1999, page 3.

As mentioned earlier, IRC § 336(a) governs Old S’s calculation of the gain or loss recognized to a liquidating corporation. That section provides:

(a) General rule. – Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation **as if** such property were **sold** to the distributee at its fair market value. (Emphasis added)

The Tax Commission is unaware of any court case that has specifically dealt with the application of IRC § 1239 to a gain as a result of liquidating distribution under IRC § 336 involving an S corporation or a C corporation. However, IRC § 1239 was applied by the Internal Revenue Service to gain recognized on the distribution of appreciated property (not in complete liquidation). See Rev. Rul. 75-514, 1975-2 C.B.116. In Revenue Ruling 75-514, individual “A” owned 92 out of 100 shares of a corporation. The corporation, pursuant to a plan of redemption, redeemed 85 shares of its stock from A. In payment for the stock redeemed, the corporation distributed a building to A, which in the hands of A was subject to the allowance for depreciation provided for in IRC § 167. The redemption qualified as “substantially disproportionate” within the meaning of IRC § 302(b)(2), and the distribution, therefore, was treated by A as payment in exchange for the stock redeemed under IRC § 302(a). The version of IRC § 311(d)(1) in effect at the time of the distribution provided, in part, that if a corporation distributes property to its shareholders in redemption of stock, and the fair market value of the property distributed exceeds its adjusted basis in the hands of the distributing corporation, then gain will be recognized by the corporation to the extent of such excess “as if the property distributed had been sold by the corporation at the time of the distribution.” The Internal Revenue Service concluded that:

The first question with regard to the applicability of section 1239 of the Code to the instant case is whether the language “as if the property distributed had been sold at the time of the distribution” used in section 311(d)(1) of the Code means that the gain realized has the same character as if the property had been sold independently of the redemption to an unrelated party, with the hypothetical cash proceeds being distributed to the redeeming shareholder. If this language has this meaning, the character of the gain to be recognized under section 311(d)(1) would not be determined under section 1239 of the Code.

While section 311(d)(1) of the Code hypothesizes a “sale” in this regard, it does not hypothesize a sale to an unrelated party. Thus, the character of the gain recognized under section 311(d)(1) of the Code is the same as if the property had actually been sold to the redeemed shareholder independently of the redemption. Therefore, section 1239 of the Code is relevant in determining the character of gain recognized under section 311(d)(1) of the Code.

Similar to former IRC § 311(d)(1), IRC § 336(a) of the Code hypothesizes a “sale”; however, IRC § 336(a) does not hypothesize a sale to an unrelated party. Thus, the character of the gain recognized under IRC § 336(a) of the Code is the same as if the property had actually been sold to the redeemed shareholder independently of the redemption. Therefore, IRC § 1239 is relevant in determining the character of gain recognized under IRC § 336(a).

The Tax Commission cannot find any logical reason why the gain relating to the distribution of a building in a partial liquidation would be subject to IRC § 1239, while a gain relating to the distribution of a building in a complete liquidation would not be subject to IRC § 1239. Therefore, the Tax Commission finds that the language found in IRC § 336 requires the distribution of property in complete liquidation to be treated as a sale. Since the distribution of property in complete liquidation is treated under federal and Idaho law as a sale, and the building in the hands of the transferee (husband) is of a character subject to depreciation under IRC § 167, IRC § 1239(a) applies.

The petitioners’ representative argues next that:

Section 336 indicates that liquidating distributions are to be reported as if sold, it makes no mention of IRC Sections 1239 being applicable. In fact, it makes specific mention of IRC Sections 1245 and 1250, which deal directly with the character of the gain. If IRC Section 1239 were applicable, there would be no reason to cite the other two sections, as all of the gain would be ordinary anyway.

Letter of protest dated November 3, 1999, page 3.

The Tax Commission has reviewed IRC § 336 and cannot locate any specific mention of IRC §§ 1245 and 1250. However, the coordination between IRC §§ 1250 and 1239 is discussed in Treasury Regulation § 1.1250-1(c)(4), as follows:⁴

(4) Treatment of gain not recognized under section 1250. Section 1250 does not prevent gain which is not recognized under section 1250 from being

⁴ Treas. Reg. 1.1245-6(f) contains similar language with respect to the coordination between IRC §§ 1245 and 1239.

considered as gain under another provision of the Code, such as, for example, section 1239 (relating to gain from sale of depreciable property between certain related persons). Thus, for example, if section 1250 property which has an adjusted basis of \$10,000 is sold for \$17,500 in a transaction to which section 1239 applies, and if \$5,000 of the gain would be recognized under section 1250(a) then the remaining \$2,500 of the gain would be treated as ordinary income under section 1239.

Clearly, the application of IRC § 1239 is not prohibited in those circumstances where IRC §§ 1245 and 1250 have been applied.

The petitioners' representative makes several other arguments as to why IRC § 1239 should not be applied in this case. The representative's other arguments are primarily based upon the representative's interpretation of legislative intent or the representative's view that the treatment of the gain as ordinary income would be unfair.

With respect to legislative intent, the Eleventh Circuit Court of Appeals in *CBS Inc., v. PrimeTime 24 Joint Venture*, 245 F.3d 1217 (11th Cir. 2001) noted that the United States Supreme Court has stated that, “[g]iven [a] straightforward statutory command, there is no reason to resort to legislative history.” *Id.* At 1222. (citing *United States v. Gonzales*, 520 U.S. 1, 6 (1997)) the Eleventh Circuit Court of Appeals went on to state that, “we do not resort to legislative history to cloud a statutory test that is clear.” *Id.* (citing *Ratzlaf v. United States*, 510 U.S. 135, 147-148 (1994)). Since, (1) the distribution of property in complete liquidation of Old S is considered a sale of Old S's property, (2) the sale is between related parties, and (3) the property is, in the hands of the husband, of a character which is subject to the allowance for depreciation provided in section 167, the statutory command of IRC § 1239 is clear, and the gain on the building must be treated by the liquidating corporation (Old S) as ordinary income.

With respect to the unfairness argument, the bottom line is that IRC § 1239 applies to the liquidating distribution at issue in this protest. While this may appear unfortunate in the present circumstances, the Idaho State Tax Commission is required to “to enforce the law as written.”

Potlatch Corp. v. Idaho State Tax Com'n, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996) (quoting, *Bogner v. State Dept. of Revenue and Tax.*, 107 Idaho 854, 856, 693 P.2d 1056, 1058 (1984)). The Idaho Supreme Court has recently stated that “[i]f the provisions of the tax code are socially or economically unsound, the power to correct it is legislative, not judicial. *Idaho State Tax Com'n v. Stang*, 25 P.3d 113 (2001) (citing *Herndon v. West*, 87 Idaho 335, 393 P.2d 35 (1964)).

CONCLUSION

There are numerous sections of the Internal Revenue Code which by their express terms apply only to either specific transactions giving rise to a loss (IRC §§ 267, 356(c), 373, 1242, 1243, 1244) or specific transactions giving rise to a gain (IRC §§ 333, 1237(b), 1239, 1245, 1246, 1248, 1249, and 1250). *U. S. Holding Co, v. Commissioner*, 44 T.C. 323, 333 (1965). The petitioners were obviously aware of IRC § 1245 and 1250, as the petitioners took these code sections into consideration when determining the tax implications of liquidating Old S. Unfortunately, the petitioners were apparently not aware of the requirement under IRC § 1239 to treat the gain relating to building as ordinary income. In *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, (1974), the Supreme Court stated:

This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not. "To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty.

Id. at 149 (citations omitted; emphasis added)

WHEREFORE, the Notice of Deficiency Determination dated September 8, 1999, is hereby MODIFIED and, as so modified, is APPROVED AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax, penalty, and interest (calculated through November 30, 2001):

YEAR	TAX	PENALTY	INTEREST	TOTAL
1995	\$ 0	\$ 0	\$ 0	\$ 0
1996	72,390	7,239	21,290	<u>100,919</u>
			TOTAL DUE	<u>\$100,919</u>

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

An explanation of the petitioners' rights to appeal this decision is enclosed with this decision.

DATED this ____ day of _____, 2001.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2001, 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:

[Redacted]
[Redacted]

Receipt No. [Redacted]

ADMINISTRATIVE ASSISTANT 1