

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 15473
[Redacted],)	
)	DECISION
Petitioners.)	
_____)	

On February 22, 2001, the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination to [Redacted] (petitioners), proposing additional income tax and interest for the taxable years 1997, 1998 and 1999, in the total amount of \$2,065. The petitioners filed a timely protest and petition for redetermination. The Tax Commission, having reviewed the entire file, hereby issues its decision.

The petitioners were residents of Idaho during the years in question. On their Idaho income tax returns for taxable years 1997 through 1999, the petitioners claimed the Idaho capital gains deduction for income derived from the removal of earth, rock, sand, and gravel from their property, the sale of stock, and a covenant not to compete. The petitioners' returns were selected for review and the Bureau determined that the depletion of a rock quarry, the sale of stock, and the covenant not to compete were not qualifying property as required by Idaho Code section 63-3022H. The Tax Commission's Income Tax Audit Bureau (hereafter "Bureau") adjusted the petitioners' taxable income accordingly and issued a Notice of Deficiency Determination.

The petitioners appealed the Bureau's determination stating they agreed that the sale of the stock and the covenant not to compete were not qualifying property. However, the petitioners maintained that they were entitled to the capital gains deduction with regard to the rock. According to the petitioners, Idaho Code section 63-3022H stated that real property was qualifying property and rock is real property. Since the petitioners held the rock for the requisite five (5) year period, the petitioners determined they qualified for the deduction.

Idaho Code section 63-3022H provided in pertinent part:

(1) If an individual taxpayer reports a net capital gain in determining taxable income, sixty percent (60%) of the net capital gain from the sale or exchange of qualified property shall be a deduction in determining taxable income.

(2) The deduction provided in this section is limited to the amount of net capital gain from all property included in federal taxable income. Net capital gains treated as ordinary income by the internal revenue code do not qualify for the deduction allowed in this section. The deduction otherwise allowable under this section shall be reduced by the amount of any federal capital gains deduction relating to such property, but not below zero.

(3) As used in this section “qualified property” means the following property having an Idaho situs at the time of sale:

(a) Real property held at least five (5) years;

Before property can qualify for the Idaho capital gains deduction, it must first qualify for capital gains treatment under the Internal Revenue Code (IRC). Therefore, the first step in determining whether income the petitioners reported relating to the depletion of the rock quarry qualifies for the Idaho capital gains deduction is to determine how the income would be treated under the IRC.

In order for the disposition of rock to qualify for capital gains treatment, it must constitute a sale and not merely a lease. If the transaction were characterized as a lease, the amounts received by the petitioners would be treated as ordinary income. On the other hand, if the disposition constitutes a sale, the amounts received by the petitioners would be treated as a capital gain. 4 Mertens, Law of Fed. Income Tax’n § 22:322 (1997). “The mining of natural resources is not usually considered to be a severance and sale of capital assets warranting capital gains treatment. . . . However, a taxpayer can receive capital gains treatment if there is a complete and total alienation of his entire interest.” Hartman Tobacco Co. v. United States, 471 F.2d 1327, 1328 (2nd Cir. 1973).

To answer the question of whether a transaction constitutes a sale or a lease, it must be determined whether the taxpayer retained an economic interest in the sand and gravel excavated. Id.; Palmer v. Bender, 287 U.S. 551 (1933). An “economic interest” is retained whenever the taxpayer has acquired by investment any interest in minerals in place, and has obtained, by any legal relationship, income from the extraction of the mineral, to which he must look for return of his capital. Commissioner v. Southwest Exploration Co., 350 U.S. 308, 314 (1956); Hair v. Commissioner, 397 F.2d 6, 8 (9th Cir. 1968); Alkire v. Riddell, 397 F.2d 779, 780 (1968). With regard to the mining of natural resources, the taxpayer will ordinarily retain an economic interest in the resources and the transaction will not amount to a sale. Generally speaking, if the consideration the taxpayer receives is tied to the production of the resource, the taxpayer will retain an economic interest. Hartman, 471 F.2d at 1328.

On September 30, 1990, the petitioners entered into an agreement with the [Redacted] regarding the removal of earth, rock, gravel, and sand from real property owned by the petitioners. The agreement terminated on February 10, 1996. Subsequently, on June 18, 1996, the petitioners and the Highway District entered into a similar agreement. According to this agreement, the term began on April 1, 1996 and terminated on April 1, 2001. The language of the 1996 agreement, which is pertinent to the tax years at issue, is as follows:

THAT [REDACTED], FOR AND IN CONSIDERATION OF THE SUMS HERINAFTER MENTIONED, DOES HEREBY GRANT AND CONVEY TO THE HIGHWAY DISTRICT THE RIGHT, DURING THE TERM OF THIS AGREEMENT, TO TAKE MATERIALS, CONSISTING OF EARTH, ROCK, GRAVEL, AND SAND, FROM THE REAL PROPERTY HERINAFTER [sic] DESCRIBED FOR HIGHWAY PURPOSES, TOGETHER WITH (a) THE RIGHT TO INGRESS AND EGRESS TO AND FROM SAID REAL PROPERTY, (b) THE RIGHT TO OPERATE EQUIPMENT ON SAID REAL PROPERTY [A]ND (c) THE RIGHT TO STOCKPILE CRUSHED ROCK ON SAID REAL PROPERTY. . . .

THE TERM OF THIS AGREEMENT SHALL BE FIVE (5) YEARS COMMENCING ON THE 1ST DAY OF APRIL, 1996 AND TERMINATING ON THE 1ST DAY OF APRIL, 2001.

THE HIGHWAY DISTRICT COVENANTS AND AGREES:

1. NOT TO ASSIGN THIS AGREEMENT, OR ANY OF ITS RIGHT HEREUNDER, OR TO SUBLET THE PREMISES HEREIN DESCRIBED WITHOUT THE PRIOR WRITTEN CONSENT OF [REDACTED].
2. THE HIGHWAY DISTRICT SHALL NOT HAVE THE RIGHT TO SELL ROCK AND GRAVEL FROM THE PREMISES HEREIN DESCRIBED.
3. THE HIGHWAY DISTRICT SHALL PAY [REDACTED] \$160 PER YEAR FOR PIT SITE RENT.

THE CONSIDERATION PAYABLE BY THE HIGHWAY DISTRICT TO HARRIS, UNDER THIS AGREEMENT SHALL BE THIRTY-FIVE (35¢) CENTS PER TON.

...

EACH YEAR THAT CRUSHING IS DONE AT THIS SITE, THE PIT ROYALTY WILL BE NEGOTIATED.

Pursuant to the above agreement, the petitioners were entitled to receive thirty-five cents per ton as well as 160 dollars per year for pit site rent. It has been held that where the predominating purpose of the agreement is the economic exploitation of the deposits, this is indicative of retained economic interest. Gowans v. Commissioner, 246 F.2d 448, 451-452 (9th Cir. 1957). Furthermore, the Highway District, as transferee, was not required to remove a minimum or maximum amount of rock from the property. When there is a fixed price per unit and transferee controls the production, as is the case here, the transferor has not transferred his economic interest in the minerals. 5 Mertens, Law of Fed. Income Tax'n § 24:26 (2000). Had the transferee been required to remove all of the rock, sand, gravel, and earth, the petitioners may have given up their entire interest. Gowans v. Commissioner, 246 F.2d at 451-452.

The payment of a fixed price of thirty-five cents per unit coupled with the right of the transferee to remove as little or as much of the minerals as it desires shows that the taxpayers retained an economic interest in the property. Therefore, the income derived from the

disposition of the minerals constitutes ordinary income rather than capital gain under the IRC. As such, the Idaho capital gains deduction does not apply. As a result, it is unnecessary to determine whether or not the property at issue was “qualifying property” as defined under Idaho Code section 63-3022H.

WHEREFORE, the Notice of Deficiency Determination dated February 22, 2001, 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 October 1, 2001):

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

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1997	\$ 404		\$ 108	\$ 512
1998	\$ 373		\$ 71	\$ 444
1999	\$ 1,049		\$ 123	\$ 1,172
		TOTAL DUE		<u>\$ 2,128</u>

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]

Receipt No. [Redacted]

ADMINISTRATIVE ASSISTANT 1