

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 17098
[Redacted],)	DECISION[Redacted]
)	
Petitioners.)	
_____)	

On November 12, 2002, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted], and to 14 of the 22 individual shareholders of [Redacted], asserting several audit adjustments to the 1999 Idaho Subchapter S corporate income tax return filed by [Redacted] and to the 1999 and 2000 Idaho individual income tax returns filed by the 14 shareholders. ([Redacted] and the 14 affected shareholders will hereinafter be referred to collectively as the “taxpayers.”) On January 14, 2003, the taxpayers filed a joint appeal and petition for redetermination. An informal conference was held in Boise, Idaho on July 14, 2003. The Tax Commission, having reviewed the file, hereby issues its decision modifying the Notices of Deficiency Determination that are the subject matter of this consolidated administrative protest.

This decision will address the issues raised in this joint administrative protest and will serve as the final decision for [Redacted]. However, to protect what may otherwise be confidential tax information unrelated to the pass-through income from [Redacted], separate decisions will be issued to each of the 14 affected shareholders. In those separate decisions the Tax Commission will incorporate by reference the Background, Issues, and Analysis provided below; but will provide a separate Order that sets out the amount owed by the individual shareholder after modification of the Notice of Deficiency Determination issued to that specific shareholder.

BACKGROUND

Prior to 1999, [Redacted] was an S-Corporation that owned the lodge at [Redacted]. On January 4, 1999, the corporation sold all of its assets for \$1.5 million in cash and a \$3.0 million note receivable. The corporation allocated the \$4.5 million selling price and the gain/loss on sale as follows:

	<u>Inventory</u>	<u>Intangibles</u>	<u>Real Property / Improvements</u>	<u>Furniture and Equipment</u>	<u>Totals</u>
• Selling Price	72,750	3,285,250	1,100,000	42,000	4,500,000
• Adjusted Basis	72,755	1,000	247,595	124,250	445,600
• Commissions	<u>-0-</u>	<u>8,876</u>	<u>2,972</u>	<u>-0-</u>	<u>11,848</u>
• Gain (loss) Realized	(5)	3,275,374	849,433	(82,250)	4,042,552

With respect to the gain realized on the sale of the Intangibles and on the Real Property / Improvements, the corporation elected to report the gain on the installment sale basis. As a result, only a portion of that gain was actually recognized in 1999. The amount recognized in 1999 was computed on the corporation's tax return as follows:

	<u>Intangibles</u>	<u>Real Property / Improvements</u>
• Gain Realized	3,275,374	849,433
• Sales Price	3,285,250	1,100,000
• Gross Profit Percentage (gain/sales price)	99.70%	77.22%
• Payments received during the year	1,095,083	366,667
• Gain Recognized (payment x profit %age)	1,091,798	283,14

Thus, the corporation reported a net capital gain on its 1999 federal return of \$1,292,688, which is made up of the \$1,091,798 gain recognized from the installment sale of the Intangibles, plus the \$283,140 gain recognized from the installment sale of the Real Property / Improvements, less the \$82,250 loss recognized from the sale of the Furniture and Equipment. [\$1,091,798 +

\$283,140 - \$82,250 = \$1,292,688].¹ This net capital gain was then reported on the Schedule K-1 forms issued to the individual shareholders as “Net section 1231 gain (loss).”

In December 1999, less than 12 months after selling its assets, the corporation was liquidated and dissolved. As part of this liquidation the \$3.0 million installment note was distributed to the shareholders of [Redacted] in exchange for their corporate stock. Thus, each of the individual shareholders realized a gain on liquidation equal to the difference between the face value of their share of the installment note received on liquidation less the adjusted basis in their corporate stock. However, the liquidation met the requirements of IRC § 453(h)(1)(A), so the gain realized by the shareholders from the sale or exchange of their corporate stock was deferred and recognized as if the stock was sold on the installment sale basis. See IRC § 453(h)(1)(A). As a result, the installment payments received by the shareholders from the note receivable distributed to them as part of the corporate liquidation are treated under the Internal Revenue Code as if they were payments for the corporate stock; not as payment for the assets sold by the corporation.

Later that same year, after the corporation was liquidated and the note receivable distributed to the shareholders, the purchaser of the corporation’s assets made a payment to the shareholders on that note. As a result, the shareholders recognized some gain from the liquidation in 1999. That gain was reported on the shareholders’ individual income tax returns on federal Form 6252 as installment sale income. This gain (hereinafter referred to as the “installment sale gain”) is distinct from the pass-through “Net section 1231 gain (loss)” reported on the K-1 forms.

¹ The \$5 loss allocated to the inventory was treated as an ordinary loss and, therefore, did not affect the net capital gain calculation.

The Commission's Income Tax Audit Division selected the corporation's 1999 return for audit. In addition the 1999 and 2000 Idaho individual income tax returns of the 22 shareholders of [Redacted] were also audited. The audit resulted in several adjustments to the corporation's 1999 (final) S-Corporation income tax return, which adjustments affected the calculation of 14 of the 22 shareholders' 1999 Idaho individual income tax returns. The audit staff also made additional audit adjustments to the 1999 and 2000 Idaho individual income tax returns of several of the 14 affected shareholders.

ISSUES

A. ISSUES RAISED IN THE LETTER OF PROTEST

[Redacted], along with the 14 affected shareholders, filed a joint protest and petition for redetermination. In that protest the taxpayers' representative disputed four of the audit adjustments made to the S-Corporation and individual income tax returns. The four audit adjustments that have been protested are as follows:

1. Disallowance of the Idaho Capital Gain Deduction relating to Non-Qualifying Property.

In addition to the normal federal Schedule K-1 issued by the corporation to the shareholders, the corporation also issued an "Idaho Schedule K-1 Equivalent" form to each shareholder. The Idaho K-1 form incorrectly listed all of the \$1,292,688 net capital gain from the sale of the corporation's assets as qualifying for the Idaho capital gains deduction. In actuality, only that portion of the net capital gain that is attributable to the sale of the Idaho Real Property / Improvements qualifies for the deduction. The gain attributable to the Intangibles clearly does not qualify for the Idaho capital gain deduction. See Idaho Code § 63-3022H(3) (defining "qualified property" for purposes of the capital gain deduction). As a result of this

error the shareholders claimed an incorrect amount of Idaho capital gains deduction on their 1999 Idaho individual income tax returns.

In addition to the amount of pass-through capital gain that was incorrectly reported on the Idaho Schedule K-1 Equivalent as qualifying for the Idaho capital gain deduction, the individual shareholders also received a payment in December 1999 (after the liquidation of the corporation) from the purchaser of the corporation's assets that resulted in the recognition of a portion of the deferred installment sale gain. Several of the shareholders treated this installment sale gain as qualifying for the Idaho capital gain deduction. The audit staff determined that none of the gain relating to the installment sale treatment of the corporate stock qualified for the deduction since the corporate stock that was exchanged for the installment note was not "qualified property."

Thus, there are two amounts that were listed by the individual shareholders as qualifying for the Idaho capital gain deduction: (1) the pass-through net capital gain from the sale of the corporate assets in January 1999 [much of which clearly relates to non-qualifying property]; and (2) the gain recognized under the installment sale method by the individual shareholders relating to the payment they received in December 1999 after the corporation had been liquidated. For ease of reference, these two amounts will be referred to as the "pass-through gain" and the "installment sale gain." It is the disallowance of any Idaho capital gain deduction on the installment sale gain that the taxpayers are protesting.

2. Recharacterization of Some of the Liquidating Distribution as Dividend Income.

The second adjustment made by the audit staff was to recharacterize some of the liquidating distribution received by the shareholders in exchange for their corporate stock as dividend income. The reason for this recharacterization is that part of the retained earnings of the corporation at the date of the liquidation related to earnings and profits retained by the

corporation years earlier when it was filing as a C corporation. The audit staff determined that these “C corporation retained earnings,” when distributed to the shareholders, are treated as dividends under Internal Revenue Code § 301.

3. Reduction of the Idaho Capital Gains Deduction as a result of IRC § 1245 Recapture.

Included in the Real Property / Improvements sold by the corporation was some property that had been depreciated under the old Accelerated Cost Recovery System (ACRS) depreciation method. Some or all of the gain realized on the sale of those assets must be recharacterized as ordinary income under either IRC § 1245 or IRC § 1250. This, in turn, lowers the amount of the pass-through Idaho capital gain deduction allowable in 1999 because the Idaho capital gain deduction does not apply to any net capital gain that is recharacterized and treated as ordinary income under the Internal Revenue Code. See Idaho Code § 63-3022H(2). The audit staff determined that this property was “section 1245 property,” which resulted in a recharacterization of \$147,523 from capital gain to ordinary income. The taxpayers’ representative asserted that the property in question was “section 1250 property” and that the amount that must be recharacterized as ordinary income is only \$8,328.

4. Recalculation of the Gross Profit Percentage used to Determine the Amount of the Installment Payments that are to be Treated as Capital Gain.

As indicated above, each of the individual shareholders reported the gain from the liquidation of their [Redacted] stock under the installment sale method. Under this income tax accounting method, the amount of installment sale gain recognized each year is determined by multiplying the payments received in that year by the “gross profit percentage.” In reviewing the shareholders’ individual income tax returns, the audit staff determined that a number of the shareholders had used an incorrect basis in calculating the gross profit percentage on federal

form 6252. Thus, the gross profit percentage was recomputed, which increased the amount of the payments received by the shareholders in 1999 and 2000 that qualified as installment sale income. The taxpayers' representative agrees with this audit adjustment in principle, but asserts that there are some additional adjustments that the audit staff should have made in recomputing the gross profit percentage. Those additional adjustments relate to the recharacterization of part of the liquidating distribution as dividend income (issue # 2 above), and the amount of IRC § 1245 / 1250 recapture that is to be treated as ordinary income (issue # 3 above).

B. SUBSEQUENT RESOLUTION OF THREE OF THE FOUR DISPUTED ISSUES

After the conclusion of the informal conference, the Tax Commission and the taxpayers agreed to a resolution to three of the four disputed issues. Namely, the Tax Commission has agreed to reverse the audit adjustment relating to the recharacterization of part of the liquidating distribution as dividend income (issue # 2 above), and the taxpayers have agreed with the audit staff's determination that a portion Real Property / Improvements sold by the corporation was "section 1245 property," which resulted in a recharacterization of \$147,523 from capital gain to ordinary income (issue # 3). Resolution of these two audit issues has resulted in a revised gross profit percentage computation (issue # 4) which the parties are now agreed upon. In addition to these agreed upon issues, the Tax Commission has also agreed to allow [Redacted] to re-allocate the gain on the sale of the [Redacted] assets based on a proposed re-allocation submitted by the taxpayers' representative. This re-allocation results in a significantly larger amount of the \$4.5 million selling price being allocated to the Real Property / Improvements, which in turn increases the amount of the net capital gain that qualifies for the Idaho capital gain deduction in 1999. The Notices of Deficiency Determination at issue in this joint administrative protest are hereby modified to incorporate all of these agreed to changes.

C. REMAINING ISSUE

The only remaining unresolved issue in this protest is whether any of the installment sale gain recognized by the individual shareholders qualifies for the Idaho capital gain deduction. The audit staff disallowed any Idaho capital gain deduction on the installment sale gain recognized in 1999 and 2000 because the payments received by the shareholders are treated under Internal Revenue Code § 453(h)(1) as payment for the [Redacted] stock that was exchanged in the liquidation of the corporation. Under Idaho Code § 63-3022H, the sale or exchange of corporate stock does not qualify for the Idaho capital gain deduction.

The taxpayers, on the other hand, assert that Internal Revenue Code § 453(h)(1) is not controlling. Rather, they submit that under Internal Revenue Code § 453B(h) the character of the gain recognized by the shareholders is the same as the character of the gain realized by the corporation when it sold its assets, some of which [namely the Real Property / Improvements] was qualifying property when it was sold. In short, the taxpayers assert that IRC § 453B(h) trumps IRC § 453(h)(1).

ANALYSIS

The taxpayers have raised a very interesting issue that requires the interpretation of not only the Idaho capital gain deduction statute, but also several provisions of the Internal Revenue Code. The Idaho capital gain deduction is found at Idaho Code § 63-3022H. During the years at issue in this administrative proceeding that section read in relevant part as follows:

63-3022H. Deduction of capital gains. – (1) If an individual taxpayer reports capital gain net income 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.

....

(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 eighteen (18) months;

(b) Tangible personal property used in Idaho for at least twelve (12) months by a revenue-producing enterprise;

.....

Idaho Code § 63-3022H (Supp. 1999). If qualified property was sold by an S corporation or a partnership, an individual shareholder or partner is allowed to claim his share of the pass-through capital gain deduction so long as that shareholder / partner held his interest in the income S corporation or partnership for the period of time required for the underlying property to qualify for the deduction. Idaho Code § 63-3022H(4) (Supp. 1999).

Had [Redacted] sold all of its qualified property in January 1999 and then recognized all of the gain in the year of sale, each of the individual shareholders (to the extent they had held their interest in the income of the S corporation for at least 18 months) would have been permitted to claim their distributive share of that gain as qualifying for the Idaho capital gain deduction. Unfortunately, that is not what happened. Instead, [Redacted] made two income tax elections that have muddied the water vis-à-vis the Idaho capital gain deduction. First, rather than recognizing all of the gain in the year of sale, [Redacted] elected under IRC § 453 to treat the gain on the sale of its Real Property / Improvements under the installment sale method of reporting income. Second, in December 1999 the corporation elected to distribute all of its assets (including the installment sale note) to its shareholders in a complete liquidation. These two elections, while clearly beneficial for federal income tax purposes, have called into question whether the shareholders are entitled to any Idaho capital gain deduction relating to gains they recognized after the distribution of the installment note.

According to the Tax Commission's audit staff, once the installment sale note was distributed to the shareholders in exchange for their stock, any gain recognized by the shareholders on that installment obligation no longer qualifies for the Idaho capital gain deduction. The audit staff relies primarily on the language found at Section 453(h)(1)(A) of the Internal Revenue Code. The taxpayers disagree. Relying primarily on the language found at Section 453B(h) of the IRC, the taxpayers argue that the Idaho capital gain deduction is not affected by the liquidation of the corporation and the distribution of the installment note. Rather, the taxpayers claim that the liquidation is essentially a "see-through" transaction and that the installment note distributed to the shareholders has all of the same characteristics as it had when held by the S corporation. Thus, under the taxpayers' reasoning, gain recognized by the shareholders after the installment note was distributed will qualify for the Idaho capital gain deduction to exactly the same extent any gain recognized by the corporation would have qualified before the distribution. Unfortunately for the taxpayers, a careful examination of the relevant Internal Revenue Code sections does not support their position.

Internal Revenue Code § 453(h)(1)(A) provides as follows:

- (h) Use of installment method by shareholders in certain liquidations.**
(1) Receipt of obligations not treated as receipt of payment. (A) In general. – If, in a liquidation to which section 331 applies, the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted and the liquidation is completed during such 12-month period, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

Id. (Emphasis added). Although perhaps not intuitively obvious, the purpose of IRC § 453(h)(1)(A) is to allow shareholders who receive an installment obligation in a qualifying liquidation to defer the gain from the liquidation of their stock. Prior to the Installment Sales

Revision Act of 1980 (which added § 453(h)(1)(A)), the receipt of the installment obligation would trigger the realization and recognition of gain or loss under IRC § 331. As a result, a shareholder would often be taxed on the gain from the liquidation of his or her stock before any payments from the installment obligation were received. The 1980 federal legislation was designed to allow the shareholder to defer recognition of the gain on liquidation until installment payments were received. To do this, the Code treats the transaction as if the shareholder has sold his stock to an unrelated third party on the installment basis, and then treats the payments made from the third party as if they were payments for the shareholder's stock. See generally Mertens, *The Law of Federal Income Taxation*, § 15:62.

Internal Revenue Code § 453B(h), which is the section of the federal tax code that the taxpayers are primarily relying on, provides as follows:

(h) Certain liquidating distributions by S corporations. If –

- (1) an installment obligation is distributed by an S corporation in a complete liquidation, and
- (2) receipt of the obligation is not treated as payment for the stock by reason of section 453(h)(1),

then . . . no gain or loss with respect to the distribution of the obligation shall be recognized by the distributing corporation. Under regulations prescribed by the Secretary, the character of the gain or loss to the shareholder shall be determined in accordance with the principles of section 1366(b).

Id. (Emphasis added). Section 1366(b) goes on to provide that “[t]he character of any item included in a shareholder’s pro rata share . . . shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.”

After carefully reviewing both I.R.C. § 453(h)(1) and § 453B(h), it appears that both of those sections apply in this case, and both can be read in harmony with each other. When read together, the two sections provide as follows:

- Payments received by a shareholder from an installment note distributed to that shareholder in a complete liquidation are treated as receipt of payment for the shareholder's stock. [§ 453(h)(1)]. However, the character of the gain or loss recognized by the shareholder in the year the payment is received is determined in accordance with § 1366(b). [§ 453B(h)].

The result, after all of these sections are put together, is that a payment received by a shareholder is treated as a receipt for payment of the shareholder's stock, but the character of the gain or loss is determined as if the payment was realized directly from the source. In short, the gain recognized by the shareholder may be characterized as "ordinary income" even though the payment is treated as a receipt for the payment of the stock (a capital asset).

As mentioned above, the purpose of IRC § 453(h)(1) is to defer the recognition of gain or loss on the distribution of the installment note that would otherwise occur under Internal Revenue Code § 331(a). IRC § 331(a) provides that "[a]mounts 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, absent IRC § 453(h)(1), the shareholders would have had to recognize the gain on the distribution of the installment note in the year the note was distributed. However, under IRC § 453(h)(1) it is not the receipt of the installment obligation that is treated as payment in exchange for the shareholders' stock; rather it is receipt of the installment payments that is treated as payment in exchange for the stock. But in either event, gain or loss is computed based on the fair market value of the property distributed less the adjusted basis of the shareholders' stock. IRC § 453(h)(1) simply allows for the deferral of that gain.

There is no question that under IRC §§ 453B(h) and 1366(b) the character of the gain recognized by the individual shareholders after the liquidation is unaffected by the § 331 liquidation. As a result, the gain recognized by the [Redacted] shareholders after distribution of the installment note is still characterized as capital gain to the same extent as it would have been if recognized by the S-Corporation. The problem is that not all capital gains qualify for the Idaho capital gain deduction. The deduction is computed on the “capital gain net income from the sale or exchange of qualified property.” Stock is not qualified property. Thus, when IRC § 453(h)(1) kicks in and treats the installment payment as a receipt of payment for the shareholder’s stock in the S-Corporation, the capital gain recognized by the individual shareholders is no longer from the sale or exchange of qualified property. While the character of the gain is unchanged (still capital gain to the same extent as if recognized by the S-Corporation), the source of the gain is from the exchange of the shareholders’ stock (non-qualifying property) and not from the sale of the underlying assets (some of which was qualifying property).

The Tax Commission is required to enforce the tax laws of this state as written. Idaho State Tax Com’n v. Stang, 135 Idaho 800, 802, 25 P.3d 113, 115 (2001); Bogner v. State Dep’t. of Revenue & Taxation, 107 Idaho 854, 856, 693 P.2d 1056, 1058 (1984). In addition, tax deductions are a matter of legislative grace and must be strictly construed against the taxpayer. Stang, supra; Potlatch Corp. v. Idaho State Tax Com’n, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996). See generally, New Colonial Co. v. Helvering, 292 U.S. 435, 440, 54 S.Ct. 788, 790 (1934) (“Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision thereof can any particular deduction be allowed.”). While the taxpayers have presented a very compelling argument as to why the capital gain

deduction should be allowed in this case, the bottom line is that the deduction does not clearly and unambiguously apply in those circumstances where an installment obligation is distributed to the shareholders in an IRC § 331 liquidation. As a result, the Tax Commission has no alternative but to disallow the deduction.

ORDER²

WHEREFORE, the Notice of Deficiency Determination issued to [Redacted], dated November 12, 2002, is hereby Modified in accordance with the agreed-to items discussed at page 7, and as so Modified is APPROVED, AFFIRMED AND MADE FINAL.

An explanation of the corporation's right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2003.

IDAHO STATE TAX COMMISSION

COMMISSIONER

² This Order applies to [Redacted]. The specific Orders that apply to the 14 affected shareholders will be set out in separate Decisions issued to each of the affected shareholders.

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2003, 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]
