

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

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| In the Matter of the Protest of |) | |
| |) | DOCKET NO. 18402 |
| [Redacted], |) | |
| |) | DECISION |
| Petitioner. |) | |
| |) | |
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On August 27, 2004, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayer), proposing income tax, penalty, and interest for the taxable years 2000 through 2002 in the total amount of \$0.

On October 21, 2004, the taxpayer filed a timely appeal and petition for redetermination. The taxpayer requested a hearing which was held June 7, 2005. The Tax Commission, having reviewed the file, hereby issues its decision.

The Income Tax Audit Bureau (Bureau) selected the income tax returns of taxpayer to review the sales of property located in Idaho. The Bureau obtained information from the taxpayer and determined the proper reporting of the property sales was as ordinary income rather than capital gain income as reported on the taxpayer's returns. The Bureau sent the taxpayer a Notice of Deficiency Determination and, because the taxpayer is an LLC, Notices of Deficiency Determination were also sent to the taxpayer's members.

The taxpayer protested the Bureau's determination stating that the primary purpose for acquiring the land was for investment. Land sales were made when the land no longer provided enough money to pay the expenses of the land, retire part of the land's debt, or when a better piece of property was found that had greater profit potential from appreciation. The taxpayer

stated all its property acquisitions were investments, and the proper characterization is capital gain.

The Bureau referred the matter for administrative review. The taxpayer requested a hearing which was held on June 7, 2005. During the hearing, the following facts were presented. In the late 1950s, [Redacted] started a sole proprietorship in which he purchased land as an investment. The property he looked for was mountainous property with timber and grazing land. [Redacted] was a motorcycle patrolman, and he started this activity while on patrol. He found properties that he believed were undervalued and purchased them for long-term appreciation. If the property had marketable timber, he arranged to have it harvested and sold. In addition to the timber, [Redacted] grazed cattle on the property. The timber and cattle sales helped to service the debt on the property.

In 1992, [Redacted] and his son, [Redacted], formed a partnership to continue the purchases of undervalued property. [Redacted] contributed some of his property to the partnership and the partnership purchased other land for investment. The property contributed to the partnership was all given an acquisition date of 1992 in the partnership's books. In 1997, the partnership was converted to a Limited Liability Corporation (LLC). [Redacted], [Redacted] ([Redacted]'s wife), and [Redacted] were the members of the LLC. The LLC's stated purpose was to operate a real estate investment and development business; to carry on any lawful business or activity; and to exercise all other powers necessary to or reasonably connected with the company's business.

[Redacted] and [Redacted] drive around the northwest looking for property they feel is undervalued and that can contribute to debt servicing through timber sales or farm share cropping. Virtually all the property acquired has had salable timber or workable farmland.

[Redacted] stopped grazing cattle on the acquired land in the 80s. The properties acquired are found by scanning the newspapers, driving the back roads of the northwest, and by word of mouth. They are mostly interested in property they feel has the potential of appreciating in value. Most if not all the property purchased is large acreages, ranches, or farms. Through its dealings over the years, the taxpayer has built up its equity and capital enabling it to deal and cash out property owners. Hence, property acquisitions can be very quick.

The trade or business of the taxpayer is to acquire property and hold it for its appreciation. The taxpayer also sells the timber and leases the property to sharecrop farmers. Generally, the taxpayer holds its property acquisitions for a number of years. However, occasionally circumstances arise where the taxpayer determines a piece of property no longer fulfills its requirements for holding that property. This occurs when property no longer produces enough income to help offset the cost of having the property. If this is determined, the taxpayer sells the property. Property sales are also made when management decides another piece of property would provide a better return on its investment than a particular piece of property it is holding. The taxpayer sells off less desirable property and buys the perceived better property. Property is also sold because management believes the market is right, and it has maximized the appreciation value. Property sales are primarily through brokers but occasionally a sale is made without a broker and even without advertising. These instances usually involve an owner of adjacent property that wants to purchase the property.

In most cases when a property is sold, it is sold as a single unit; however, there are exceptions. During the years examined, the taxpayer had sales from four large parcels that were divided into smaller units. The taxpayer stated this was done in order to sell or liquidate the properties. In each instance, the taxpayer found the original parcels were too large to sell as a

single unit. Consequently, the taxpayer divided the properties into smaller parcels. One of the properties, [Redacted], located in [Redacted] was divided into 20-acre parcels. Another was [Redacted], located in Idaho. Dividing these large parcels into smaller parcels is about the extent of the taxpayer's "improvements" to its property holdings. The only other improvements the taxpayer made to a piece of property was making power accessible to property located in Idaho.

The taxpayer's operation consists of three people. [Redacted] and [Redacted] do the "field" work (finding properties) and [Redacted], no relation, runs the day-to-day operations of the taxpayer's office. The office is open four days a week and is currently located in a business park but not on the ground floor. [Redacted]'s and [Redacted]'s principal responsibilities are locating, inspecting, and assessing potential new investment properties. They also manage the existing properties through safeguarding, conservation, reforestation, weed control, stream habitat, and by maintaining access roads, culverts, cattle guards, and out buildings. Other duties include in-office paper management, personnel management, and property management coordination. [Redacted]'s responsibilities are the accounting and all the other general office duties. Recently, [Redacted] and [Redacted] have pulled in their daughter/sister to help in the office.

The taxpayer's preferred method of selling its properties is by means of an installment contract. [Redacted] prefers this method because it provides a type of retirement annuity. The taxpayer is in a position that it can carry contracts, which in some cases assisted in making the sale of the property. However, installment sales are not the only method used; cash sales are also accepted.

Over the audit period, the taxpayer owned and held on average 10-12 parcels of property. In the same period, the taxpayer made 21 sales broken down as follows: 2000 – 12 sales; 2001 –

5 sales; and 2002 – 4 sales. The total sales reported on the installment basis were 65 with sale dates ranging from 1994 to 2002. Cash sales from 2000 to 2002 numbered 7. Of the properties sold during the audit period, all but one sale were divided parcels of the two previously mentioned larger parcels located in either [Redacted]. The other sale was sold as a whole unit. That property was located in Idaho.

The whole unit sale in Idaho was atypical of the properties held by the taxpayer. The taxpayer purchased the property with the intent of holding it for a long period. The taxpayer believed when it purchased the property that it could get the county to assist in improving the road access to the property. The taxpayer had the Idaho Department of Lands and the Idaho Department of Fish and Game review its proposal for the road improvement. The Department of Fish and Game decided the work would disturb fish habitat on a creek that had to be diverted, so it did not approve the plan. The county also decided not to assist in improving the road. Without the road improvements, access to the property is severely limited in the spring and fall. The poor road conditions made it difficult to access the timber on the property and farm the property. Since the taxpayer was not going to get the road improvements and the accessibility affected the farming operations and timber harvesting, the taxpayer decided that the property could not support the expenses of the property. Therefore, the taxpayer marketed the property, as it does with most of its property, in areas where it believes it can maximize its profits. In this case, an individual from California purchased the whole property at a substantial gain for the taxpayer.

The taxpayer's purpose for purchasing and holding the properties was provided in examples of typical property purchases. The taxpayer purchased property in Idaho that had significant salable timber on the property for approximately \$300,000. After acquiring the property, the taxpayer received an unsolicited offer to buy the property from Boise Cascade

Company. The taxpayer purposely held the property for the required length of time to get the capital gains treatment on the sale of the timber and then sold both the timber and land for over \$800,000. Another purchase was about 10 years ago when the taxpayer purchased property near Spokane, Washington for approximately \$75,000. That same property is now worth over \$4,000,000 and is still being held by the taxpayer. And then there is the property sold in Idaho that is a significant part of this audit. The taxpayer purchased the property for approximately \$150,000 and it sold for over \$600,000.

In addition to gains on the sale of property, the taxpayer, as mentioned earlier, also sold timber. The timber sales were more substantial in the late 1990's; however, there were still sales made in 2000 and 2001. Other income the taxpayer received was rental income from its property being leased to farmers and others for their private use. This income is relatively small (less than \$50,000), but it is a consistent source of income for the taxpayer beginning in 2000.

The taxpayer's management is not interested in developing the properties owned by the taxpayer. There have been opportunities where the taxpayer could have made substantial gains if it developed a particular piece of property. However, rather than develop the property itself, the taxpayer sold the property to a developer. This is illustrated by the sale of property the taxpayer owned near an interchange between Spokane, Washington and Coeur d'Alene, Idaho. The taxpayer sold the property to a developer who developed the property into what it is today. The taxpayer's elder member has no interest in developing property.

The issue to be determined in this case is whether the property sold by the taxpayer is taxed as ordinary income or as capital gain. Internal Revenue Code (IRC) section 1221 states in pertinent part,

Capital asset defined

(a) In general. For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his

trade or business), but does not include—

- (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; . . .

In Malat v. Riddell, 383 U.S. 569, 572 (1966), the Supreme Court explained the purpose of section 1221(1) as follows:

The purpose of the statutory provision . . . is to differentiate between the "profits and losses arising from the everyday operation of a business" on the one hand (*Corn Products Refining Co. v. Commissioner of Internal Revenue*, 350 U.S. 46, 52) and "the realization of appreciation in value accrued over a substantial period of time" on the other. (*Commissioner of Internal Revenue v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134.)

Therefore, for ordinary income treatment, the taxpayer has to be in the trade or business of selling real property. The taxpayer claims all properties are held for investment, the realization of gain through appreciation. In determining whether gains realized from the sale of property are capital gains or income derived from the sale of the property in the ordinary course of business, the Court in Suburban Realty Co. v. United States, 615 F.2d 171 (1980), stated it is important that the proper questions be asked that are demanded by the statute. Those questions are:

- (1) was the taxpayer engaged in a trade or business, and, if so, what business?
- (2) was the taxpayer holding the property primarily for sale in that business? and
- (3) were the sales contemplated by the taxpayer "ordinary" in the course of that business?

The statutory language does not demand that property actually be sold while a taxpayer is still actively engaged in its trade or business for ordinary income treatment to be required.

Rather, it demands that the property has been held primarily for sale in that business. Suburban Realty Co. v. United States, supra.

Determining whether a taxpayer's activities rise to a level which constitutes "carrying on a business" requires an examination of the facts in each case. Higgins v. Commissioner, 312 U.S. 212, 217 (1941). To assist in determining whether a taxpayer is in the trade or business of selling real estate, the courts have looked to as many as nine and as few as four factors. These factors are (1) the taxpayer's purpose in acquiring the property and the duration of his ownership, (2) the purpose for which the property was subsequently held, (3) the taxpayer's everyday business and the relationship of realty income to total income, (4) the frequency, continuity, and substantiality of sales of property, (5) the extent of developing and improving the property to increase sales, (6) the extent to which the taxpayer used advertising, promotion, or other activities to increase sales, (7) the use of a business office for the sale of property, (8) the character and degree of supervision or control the taxpayer exercised over any representative selling the property, and (9) the time and effort the taxpayer habitually devoted to the sales. United States v. Winthrop, 417 F.2d 905, 910 (5th Cir.1969). Many of these same facts have been used to support both an "investment" holding and a "trade or business" holding. Although these factors may aid the finder of fact in determining, on the entire record, the taxpayer's primary purpose for holding property, they have no independent significance, and individual comment on each factor is not necessary or required. Wood v. Commissioner T. C. Memo 2004-200, citing Suburban Realty Co., supra; Hay v. Commissioner, T.C. Memo.1992-409.

The taxpayer in this case purchased large tracts of undervalued land with the intent of holding the property for its appreciated value. The land was all mountainous property and generally had merchantable timber on it. The taxpayer's usual course of action was to acquire

the property, hold it for the required time to get the capital gain treatment on the timber, sell the merchantable timber, and then continue to hold the property for its appreciated value. If the land could support farming activities, the taxpayer would lease portions of the property to sharecrop farmers.

The taxpayer did not develop or improve the properties. The taxpayer's members managed the properties by coordinating timber harvesting, sharecrop leases, and hunting leases. They maintained the properties by checking the physical security (gates and fences); doing upkeep on the access roads, culverts, cattle guards, and any outbuildings; they monitored or investigated illegal trespassing; planned and coordinated surveys to establish legal boundaries and easements; and they planned for conservation, reforestation, weed control, and stream habitat.

The taxpayer's typical land acquisition is large tracts of land of several hundred acres. The taxpayer holds the land until it believes the property has hit its maximum appreciation or it receives an offer on the property that the taxpayer believes maximizes the profit potential. In rare cases, the taxpayer will sell property because the property does not meet its expectations or the property no longer helps to sustain itself. During the audit period, there was such a property.

The taxpayer purchased the [Redacted] (Idaho) property in 1999. The taxpayer believed part of this property could be farmed and it also had merchantable timber. The taxpayer did lease the farmland for three seasons. The property was accessed via an improved county road up to a certain point. After that, the road was unimproved to the taxpayer's property making access to the timber and farmland difficult from fall through spring. The taxpayer attempted to get the county to extend the road improvements but was unsuccessful. The county said it would be onerously expensive and not the best use of its resources. The taxpayer also failed to get

approval from the Idaho Department of Fish and Game on its plan to improve the road. As a result, the taxpayer's management felt it was not cost effective to maintain year round access to the property for timber harvesting and farming. Management determined the property would not meet its long-term objectives, so the property was sold, churned, or culled.

The extent of development activity and improvements is an important factor in deciding whether the real estate activity is a trade or business. Suburban Realty Co., supra. The taxpayer's development/improvement activities were virtually nonexistent. The taxpayer did divide large tracts of land into smaller tracts when it found it could not sell the original tract as a single unit. The record shows this was done on two properties during the audit period and maybe two other properties outside the audit period. Of the two during the audit period, one was an original tract, in [Redacted], of over 3,000 acres. The property was purchased in 1992 or before, and in order to sell the property the taxpayer divided it into smaller acreages beginning in 1998. Approximately 2,900 acres of this Washington property was sold in 28 sales; a few of the sales were to the same buyers in previous years. The other divided property, located in Idaho, was purchased in 1998 and sold in smaller acreages beginning in 1999 through 2001. Of the 69 known sales since 1994, 62 of the sales were from 4 large tracts divided into smaller acreages.

As for improvements, the record shows and the taxpayer admits one improvement on one piece of property. On the [Redacted] property in Idaho, the taxpayer brought in electricity to the spring or creek for pumping water. Other than this one instance, all the lands purchased were unimproved by the taxpayer.

It could be argued that the taxpayer was in the business of buying and selling unimproved land and, consequently, improvements were not necessary. However, all aspects of a case must be considered in order to decide whether the taxpayer was an investor or a dealer in real estate. W.

T. Thrift, Sr., 15 T.C. 366 (1950). Failure to do anything significant to the properties to make them more attractive to potential purchasers provides very significant proof that the taxpayer was not operating a business. Adam v. CIR, 60 T.C. 996 (1973). In Farley v. CIR, 7 T.C. 198 (1946), the court stated,

It is unquestionably true that the frequency and continuity with which a particular activity is carried on is a primary consideration in determining whether such activity constitutes a trade or business. It is significant to note, however, that the cases which have applied this test to real estate transactions involved elements of development and substantial sales activity which are essentially lacking in the instant case. See Richards v. Commissioner, 81 Fed.(2d) 369; Snell v. Commissioner, 97 Fed.(2d) 891; Welch v. Solomon, 99 Fed.(2d) 41; Ehrman v. Commissioner, 120 Fed.(2d) 607; Oliver v. Commissioner, 138 Fed.(2d) 910; Gruver v. Commissioner, 142 Fed.(2d) 363; Brown v. Commissioner, 143 Fed.(2d) 468; James Lewis Caldwell McFadden, 2 T.C. 395. In none of these cases did the taxpayer maintain the passive posture held by petitioner in the instant case.

Regarding the sales activities of the taxpayer, the taxpayer has no sales staff or sales office. The taxpayer's office is open four days during the week from 8:00 a.m. to 4:00 p.m. The office is closed on eight holidays, and it is not uncommon that the office is closed for extra days around the holidays. The primary purpose of the office is to have a location for the taxpayer where its books and records are maintained, where the members can discuss the financial aspects of the taxpayer, where the members can coordinate asset management, and where the members can discuss investment strategy. Of the time spent as members of the taxpayer, only one member spends approximately 5% of his time in selling the taxpayer's property. When management determines it is time to sell off some of its holdings, an "Exclusive Seller Representation Agreement" is entered into with a real estate broker. Neither the taxpayer nor its members have ever held a real estate broker's license or have been part of a real estate organization. The broker's responsibilities were to advertise the property and to bring the buyer and the taxpayer

together. The taxpayer also did limited advertising for both selling and buying property.

The taxpayer's stated purpose or intent for purchasing and owning real property is for investment; to realize gain through the appreciation of the property over time. While the intention at the time of acquiring the property is appropriate for consideration, it is not controlling. "The ultimate question of decisive consequence was the purpose for which he was holding the property at the time of the sales." Friend v. Commissioner, 52-2 USTC, ¶9428. A taxpayer's purpose in holding property may change; therefore, the character of the property for tax purposes may be different at the time of sale than at the time acquired. Klarkowski v. Commissioner, T.C.Memo. 1965-328, (24 TCM 1827). There may also be externally induced factors or events forcing an alteration of plans causing a change in the character of property. While the purpose the property was held at the time of sale is determinative, earlier events may be looked at to determine precisely what the purpose was at the time of sale. Biedermann v. Commissioner, 68 T.C. 1 (1977), citing Maddux Construction Co. v. Commissioner, 54 T.C. 1278 (1970).

An appropriate question to ask is what was the taxpayer's primary holding purpose before it decided to make the sales in dispute. The "holding purpose" inquiry may appropriately be conducted by attempting to trace the taxpayer's primary holding purpose over the entire course of his ownership of the property. Malat v. Riddell, supra. Therefore, the taxpayer's primary purpose for acquiring the property becomes the starting point. In this case, the taxpayer stated that all properties were acquired as investments. That being the case, is there evidence of a change in taxpayer's primary holding purpose? The record does not show that the taxpayer did anything with its properties other than harvest the timber and lease the farmable land. These two activities do not change the character of the property. When the taxpayer decided it wanted to sell some of its properties, the taxpayer found it necessary to divide some of the properties into

smaller acreages. A holding that property is not part of a business only so long as it is sold in large blocs, but not if it is sold in small parcels, discriminates irrationally against an investor who decides on liquidation but cannot locate purchasers interested in large acquisitions. Biedenhard Realty Co. Inc. v. United States, 526 F.2d 409 (1976) (Gee, J., dissenting). In this case, the taxpayer could not always find a buyer for its property as a single unit. Therefore, the taxpayer divided the larger tracts it wanted to sell into smaller acreages. The record states that the taxpayer had the properties surveyed, but there is no record that the taxpayer subdivided this mountainous property into what is commonly thought of as a subdivision. Merely disposing of investment assets at intermittent intervals, without more, is not engaging in business, even though some preliminary effort is necessary to render the asset saleable. Fahs v. Crawford, 161 F.2d 315 (1947) citing Snell v. Commissioner, 5 Cir. 97 F.2d 891.

What all this boils down to is whether the taxpayer engaged in a sufficient quantum of focused activity to be considered to be engaged in a trade or business. Suburban Realty Co., supra. The Commission found absent in this case the elements of development and sales activities which distinguish it from a number of the cases cited. In addition, the Commission found other circumstances which explained the frequency and continuity of sales in terms other than those connotating business activity. In Boomhower v. United States, 74 F.Supp. 997 (N.D. Iowa 1947), the court stated,

It would seem that to carry on a business conveys the idea of progression, continuity and sustained and normally incident activity, and does not mean the performance of single disconnected acts. Continuity, in the case of a real estate enterprise, would hence seem to connote that characteristic of the business as a 'going concern,' as distinguished from sporadic activity lacking the studied purpose or continuing objective of the entrepreneur-realtor. The occasional purchase and resale of land by an investor speculating on a rise in real estate values, does not, in the absence

of other circumstances, give rise to the status of his being a dealer in real estate.

When a taxpayer buys and sells undeveloped real estate, when he performs no significant activities in purchasing, developing, or selling the properties, when he engages in only a few transactions, and those sporadically, and when he devotes no substantial time to the real estate transactions, his activities resemble those of a person who invests in the stock market with the objective of buying and selling speculative stocks. Only occasional purchases and sales of real estate or stocks with the hope of realizing a gain on their subsequent increase in value, without more, does not constitute a trade or business. Adam v. CIR, supra. Judge Gee's statement in his dissenting opinion to Biedenhard Realty Co. Inc. holds a lot of truth in these types of cases, "And while I entirely agree with the majority's redundant warning that 'once an investment does not mean always an investment,' id. at 423, I would also suggest that once a sale does not mean always a business."

Review of the information provided by the taxpayer and available in the file has convinced the Tax Commission that the taxpayer's property sales did not meet the level of a trade or business. Therefore, the characterization of the gain realized on the sale of the properties was properly classified as capital gain.

WHEREFORE, the Notice of Deficiency Determination dated August 27, 2004, is hereby CANCELLED.

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

DATED this ____ day of _____, 2005.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2005, 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]
[Redacted]

Receipt No.

[Redacted]
[Redacted]
[Redacted]

[Redacted]
[Redacted]
[Redacted]
