BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted], Petitioners.	))))))	DOCKET NOs. 17852 and 17858 DECISION

On November 10, 2003, the Income Tax Audit Bureau (Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] for tax year 2002. On November 20, 2003, a separate Notice of Deficiency Determination was issued to [Redacted] for tax year 2002. The adjustments proposed by the Bureau in the NODD issued to [Redacted] did not result in any additional tax due by [Redacted] since [Redacted] filed as a partnership; however, the adjustments do have a tax impact to its members. One hundred percent of the profit and loss generated by [Redacted] for tax year 2002 was allocated to [Redacted] resulting in the separate NODD issued to the [Redacted] proposing additional income tax and interest in the total amount of $31,917. Both [Redacted] filed a timely protest and petition for redetermination. A joint hearing on the petitions was held on September 29, 2005. At the hearing the petitioners agreed that, if a decision was to be issued, it was acceptable to combine both petitions into one decision. The Tax Commission, having reviewed the file, hereby issues its decision.

In the [Redacted] NODD the Bureau allowed additional basis for a subdivision lot sold in 2002 that was not previously claimed as a deduction and reclassified $474,579 of gain from the 2002 subdivision lot sales as ordinary income. [Redacted] had treated the gain as capital gain. [Redacted] does not dispute the Bureau's allowance of additional basis; however, [Redacted] does protest the Bureau's treatment of profit on the sale of land as ordinary income. Therefore, the primary issue before the Commission is a determination of the proper character of the gain from the sale of the lots.

[Redacted] asserts that under Internal Revenue Code section 1221 each lot sale qualifies as a sale of a capital asset and is entitled to capital gain treatment. The Bureau asserts that the lot sales would not qualify as sale of a capital asset under Internal Revenue Code section 1221(1) since the lots were sales of property held by [Redacted] primarily for sale to customers in the ordinary course of [Redacted]'s trade or business. In order for the gain on the sale of the lots to qualify for favorable treatment as long-term capital gain under federal law and for that matter under Idaho law, the gain on the sale must be from the sale of a capital asset. The sale does not qualify for capital gain treatment if the sale is a sale of property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This determination is a factual determination and has been the subject of substantial litigation over a number of decades at the federal level.

--BACKGROUND—

[Redacted] along with [Redacted], an unrelated third party, entered into a Memorandum of Understanding in June of 1999 to acquire, develop, and sell real property. In July of 1999, the [Redacted] along with [Redacted]entered into a contract to purchase approximately 49.1 acres of undeveloped land. In August of 1999, the [Redacted] and [Redacted] formed [Redacted], an Idaho Limited Liability Company, for the purpose of [Redacted].

In February of 2000, [Redacted] entered into a contract to purchase 5.4 acres of undeveloped land. In October of 2000: (1) the [Redacted] purchased [Redacted]'s 50 percent interest in [Redacted] leaving the [Redacted]s as the remaining members of [Redacted] (2) [Redacted] entered into an Independent Contractor Agreement with [Redacted], the former shareholder of [Redacted], to utilize the services of [Redacted] on an as needed basis in assisting in the platting, construction, development, marketing, and sale of the [Redacted] lots; and (3) [Redacted]'s name was changed to [Redacted] In November of 2000, the [Redacted] and [Redacted] assigned to [Redacted] their right to purchase the 49.1 acres of undeveloped real property.

From June of 1999 through November of 2000, Mr. [Redacted] had been providing various services relating to the development of the [Redacted]. In early December of 2000, the [Redacted] became unhappy with the services provided by Mr. [Redacted] and began taking steps to terminate the Independent Contractor Agreement.

In January of 2001, [Redacted] finalized the acquisition of the 5.4 acres of undeveloped land and on September 11, 2001, finalized the acquisition of the 49.1 acres of undeveloped land. It was these two parcels of land that were combined to become known as the [Redacted]. Additionally, from January of 2001 through November of 2001: (1) [Redacted] incurred over one million dollars in development expenses; (2) the initial engineer hired for the project was terminated and another engineering firm was hired; (3) [Redacted] was hired to perform construction management services; (4) the [Redacted] Convents, Conditions, and Restrictions were finalized; (5) [Redacted], the original management consultant, filed a lawsuit against [Redacted] [Redacted] and the [Redacted]s; (6) a real estate agent was hired to market and sell the [Redacted] lots, and (7) Mr. [Redacted] approved the listing price for 37 of the lots reflecting a total value in excess of seven million dollars.

In December of 2001, in an apparent attempt to circumvent the Independent Contractor Agreement and to gain capital gain treatment for the lots to be sold: (1) [Redacted] was formed; (2) [Redacted].'s members approved the sale of the [Redacted] to [Redacted] for approximately three million dollars ([Redacted]'s basis in the property per the petitioners' representatives) resulting in no gain or loss on the sale and no money due to [Redacted] under the Independent Contractor Agreement from the sale of the property (under the Independent Contractor Agreement, Mr. [Redacted] was to be paid a consulting fee equaling 25 percent of the gain on the sale of the property); (3) the creation of various documents in an attempt to support the three million dollar plus sales price; and (4) the recording through [Redacted] the transfer of the [Redacted] property from [Redacted] to [Redacted].

[Redacted] was created on December 4, 2001, as an Idaho Limited Liability Company.[1] The stated business purpose of [Redacted] at the time of formation was to "invest in real estate, and to transact any and all other business for which limited liability companies may be formed under Idaho law."[2] On April 10, 2002, [Redacted] was deposed in the case of [Redacted]. Additional explanation for the creation of [Redacted] is found in the testimony given by Mr. [Redacted] in response to questions posed by Mr. [Redacted]'s attorney as follows:

Page 10 of the disposition:

> Q. Did you obtain any written opinions from your accountants on any aspect of the transaction [referring to the acquisition of the [Redacted]by [Redacted]]?
> A. [[Redacted]] My accountant had recommended formally from a tax standpoint that it would be prudent to have a – take a long-term prospective on trying to get capital gains treatment as opposed to ordinary income treatment which I would have received under the prior ownership structure.

Page 12 of the disposition:

> Q. Was [Redacted] formed for the purpose of acquiring the [Redacted] [subdivision] project?
> A. [[Redacted]] [Redacted] was formed in an effort again to try to get capital gains tax treatment on future sales of lots within the development.

[1] Articles of Organization Limited Liability Company filed with Idaho Secretary of State.
[2] [Redacted]'s December 4, 2001, Operating Agreement, page 2, Section 1.8.

Page 13 of the disposition:

> Q. In the course of that transaction of selling [Redacted] [subdivision] to [Redacted] did you ever become aware of an issue as to how this lawsuit may affect the ability of [Redacted] [[Redacted]] to transfer that property?
> A. [[Redacted]] Again the intent of the transfer is to try to attain capital gains tax treatment by the IRS.

[Redacted] elected to be treated as a partnership for federal income tax purposes and filed a federal partnership return for tax year 2002. The 2002 return was [Redacted][Redacted]'s initial return. [Redacted]'s members and the members' interests for tax year 2002 were as follows:

Member Name	Profit/loss Sharing Percentage[3]	Ownership of Capital Percentage[4]	Tax Matters Partner[5]
[Redacted]	50%	45%	■
[Redacted]	50%	45%	
[Redacted]	0%	10%	

The lots sold in 2002 were part of the [Redacted]. The official plat map lists the name of the subdivision as [Redacted]; however, since the majority of documentation provided to or obtained by the Commission refers to this property as being part of the [Redacted], the Commission will refer to the property in the remainder of this decision as the "[Redacted]."[6]

3. The [Redacted] And Lot Sales

The [Redacted] is located in the vicinity of [Redacted], Idaho near the intersection of the streets [Redacted].[7] The subdivision is situated in the center of three existing subdivisions, [Redacted], [Redacted], and [Redacted].[8] The [Redacted] is approximately 56.23 acres in total and consists of 9 separate blocks of which Blocks 1 through 4 and Block 9 are common areas

[Redacted][Redacted] 2002 federal income tax return, schedule K-1.
[4] [Redacted]'s December 4, 2001, Operating Agreement, page 2, Section 1.10.
[5] [Redacted]'s December 4, 2001, Operating Agreement, page 9, Section 5.4.
[6] Plat of [Redacted] filed on [Redacted], with the [Redacted] County Assessor's office.

leaving Blocks 5 through 8 as the blocks containing the lots on which homes could be built. Blocks 5 through 8 consist of 42 lots of which 41 are suitable for homebuilding. Blocks 5, 6, 7, and 8 contain 11 lots, 16 lots, 8 lots, and 7 lots respectively. The one acre or greater lots range in price from $115,000 to $595,000. Lot 10 of Block 6 is an oddly shaped lot located below the [Redacted] lots and is the only lot that was not listed as a lot for sale since it was deemed a nonbuildable lot.

The highest priced lots are the lots located in Block 6 bordering a ridge that overlooks part of the [Redacted] and the [Redacted]. The total listing price for all the saleable lots exceeded eight million dollars resulting in a projected four million dollar or greater profit for the sellers if all of the lots sold for the listing price.[9] As discussed in more detail below, the majority of the property that makes up the [Redacted] had been acquired from [Redacted]. Included in 41 buildable lots are Lots 4 and 6 of Block 6 which are part of a life estate granted to the [Redacted]. Title to lots 4 and 6 will transfer to [Redacted] upon expiration of the life estate.[10] Additionally, lot 5 of block 6 is tied up to some extent as a result of the life estate since the [Redacted]' home sits on lot 4 and their barn sits on lot 6 with lot 5 in between and fenced in.[11]

Of the 41 lots listed for sale, the first [Redacted] lot sold by [Redacted] occurred in February of 2002. In 2002, [Redacted] sold a total of nine lots and exchanged one lot (lot 12, Block 6) as part of a settlement agreement to resolve outstanding litigation leaving a total of 31 lots suitable for homebuilding for sale as of the end of 2002.[12]

The lots, reported by [Redacted], as having been disposed of in 2002 were as follows:

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[7] The address listed on the buyer's closing statements reflects the property as being part of [Redacted]; however, the property was later annexed by the [Redacted].
[8] Plat of [Redacted], with the [Redacted] County Assessor's office.
[9] Per unnamed and undated schedule provided to Commission audit staff by petitioners' representative.
[10] Section 1.b of the [Redacted] dated July 27, 1999.
[11] Letter from [Redacted]'s representative dated February 14, 2005.

Lot	Block	Date Sold	Sales Price	Cost	Gain
2	8	02/20/02	$115,000	$74,697	$40,303
6	8	02/21/02	$150,000	$89,396	$60,604
3	6	04/19/02	$139,900	$87,873	$52,027
3	8	05/24/02	$131,900	$87,014	$44,886
4	5	06/19/02	$130,600	$87,182	$43,418
2	6	06/26/02	$149,900	$89,242	$60,658
12	6	06/28/02	$0	$0	$0
5	8	08/09/02	$150,000	$95,574	$54,426
4	8	08/16/02	$131,900	$88,030	$43,870
7	8	12/23/02	$170,000	$95,613	$74,387
Totals			$1,269,200	$794,621	$474,579

As of February 2005, the [Redacted].com website, lists six lots remaining for sale and identifies [Redacted] as exclusively marketing the remaining lots; however, in the past, the property has been marketed by [Redacted], [Redacted]. Included in the remaining six lots are the three lots previously discussed as being tied up as part of a life estate.

The complex history behind the acquisition, development, and sale of the [Redacted] to [Redacted] is detailed in Appendix A of this Decision.

PETITIONER'S ARGUMENTS

[Redacted]'s representative argues for investment treatment (i.e. capital gain treatment) in his letter dated January 12, 2004, as follows:

> [Redacted] purchased acreage for their current personal residence in 1992. They built their home and moved in to their house August of 1994. It was approximately the same time when they began having correspondence with the owners regarding purchase of the subject property. They had made a considerable investment in their acreage and residence, so they decided to pursue purchasing the adjacent property to control the activities of the area and they thought it would be a prudent long-term investment. . . . [Redacted] is President of [Redacted], a [Redacted] . . . and [Redacted] is an [Redacted]. Mr. [Redacted] has spent twenty-two

[12] [Redacted] may have distributed lots 5 through 9 to its members [Redacted] however, the record is unclear as to when or if these lots were actually distributed to these members.

> years with [Redacted] and spends a minimum of 60 to 80 hours per week with his job responsibilities. Mrs. [Redacted] is the owner of [Redacted] since 1990. She worked for a group at [Redacted] from 1981 through 1990. It would be ludicrous to consider either [Redacted] or [Redacted]as real estate developers or in the trade or business of developing real estate. The majority of their income is derived from their respective professional jobs, not from the sale of their investments.
>
> When [Redacted](via a prior venture) purchased the property in 1998 they had no intentions of developing the property. As the closing kept getting delayed due to the seller's poor health and problems with legal counsel, it was becoming obvious that the economy was in a severe downturn. Large local employers were laying off and downsizing, making large residential lots less desirable. [Redacted] decided in early 2001 that the most prudent thing to do with their investment would be to hire someone to subdivide and sell the parcels. This became even more apparent after the incidents of September 11, 2001. In *Heller Trust v. Comr., 382 F.2d 675 (9th Cir. 1967)*, the court stated that where the facts clearly demonstrate that a taxpayer held certain property as an investment, and further show that this purpose continued until shortly before the time of a sale, and that the sale is prompted by a liquidation intent, the taxpayer should not lose the benefits provided by the capital gain provisions.
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> . . . [Redacted] is President of [Redacted] . . . [Redacted] is an [Redacted] . . . Neither has ever been in the trade or business of developing and/or selling real estate.

In responding to a case cited by the Commission's audit staff, the representative states in the January 12, 2004, letter that in *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969):

> . . . the court identifies seven factors that are considered in making the determination if a sale of a subdivided lot is in the ordinary course of trade or business. These factors are (1) the nature and purpose of the acquisition of the property and the duration of the ownership. [Redacted] purchased the land as an investment because it was contiguous to their current residence. Only when the economy started to show signs of distress, did they decide to liquidate their investment. (2) the extent and nature of the taxpayer's efforts to sell the property. The [Redacted]'s are not real estate professionals. Accordingly, they hired people to develop the property and hired a local real estate broker, [Redacted]., to list and sell the property. (3) the number, extent,

continuity, and substantiality of the sales. There are 41 lots that are being sold. Once the lots are sold, [Redacted] will liquidate and distribute net proceeds to the partners since the investment in real estate will cease and the partners of [Redacted] are not real estate professionals. (4) the extent of subdividing, developing, and advertising to increase sales. [Redacted]has signed an exclusive listing with [Redacted]. for all the property that was purchased and subdivided. (5) the use of a business office for the sale of the property. As mentioned in number (4) above, [Redacted] has no business office for the sale of the property. [Redacted] is in complete control of how they market and exert energy for the sale of the subdivided lots. (6) the character and degree of supervision of control exercised by the taxpayer over any representative selling the property. In reference to the listing [Redacted] has with [Redacted]., [Redacted] has no control and/or supervision as long as [Redacted], sells the lots. (7) the time and effort the taxpayer devoted to the sales. As President of [Redacted], [Redacted], has no time to devote to the sale of the subdivided lots, nor does [Redacted], who is an [Redacted]. It is obvious to the taxpayers, that they would miserably fail the seven factor analysis from the [Redacted] case, as relied upon by the Commission.

LAW AND ANALYSIS

The determination of gain from the sale of subdivided lots as capital or ordinary is controlled by the language of the Internal Revenue Code.[13] IRC section 1237 is a special capital gains provision that allows a qualifying taxpayer to sell lots from a single tract held for investment without any of the resulting gain being taxed as ordinary income solely because the tract was subdivided or because he actively participated in the sales, provided, however, certain conditions are met. The petitioners acknowledge that the conditions set forth in IRC section 1237 were not met.[14] Instead, the representative argues that capital gains treatment is still warranted in accordance with IRC section 1221.

Internal Revenue Code section 1221 reads, in pertinent part, as follows:

> Sec. 1221. 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), <u>but does not include</u>
>
> (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 <u>property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business</u>;
>
> . . .

(Emphasis added.)

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

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[13] Unless otherwise indicated, references in this decision to sections of the Internal Revenue Code are to the applicable section of the Internal Revenue Code of 1954 for the years at issue.
[14] See page 7 of the petitioners' Pre-Hearing Memorandum, dated September 27, 2005.

> 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.)

Thus the central issue becomes one of whether or not the gain from [Redacted]'s real estate sales is treated as ordinary income because the sales fall within the exception covering "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." However, before turning to the central issue raised in this protest, the Commission must first determine whether the sale should be analyzed at the partnership/entity level or at the partnership/owner level.

In *Phelan v. Commr.*, T.C. Memo 2004-206, in dealing with a IRC section 1221(1) issue involving an income distribution as a result of a sale of land by [Redacted] limited liability company, to another LLC created and owned by the same members that owned JCLC, the Tax Court stated that the court:

> Must consider the character of the gain at the entity level *Cannon v. Commissioner*, 949 F.2d 345 (10th Cir.1991), affg. T.C. Memo.1990-148; see *Brannen v. Commissioner*, 78 T.C. 471, 1982 WL 11168 (1982), affd. 722 F.2d 695 (11th Cir.1984); *Podell v. Commissioner*, 55 T.C. 429, 1970 WL 2303 (1970). More particularly, we must decide whether JCLC held the Jackson Creek property for sale in the ordinary course of its business or whether it was held as a capital asset.

Citing IRC section 702(b), the Tax Court made it clear that the character of the income (capital or ordinary) to partners and LLC members is determined by its character **at the entity level**.

The entities involved with the property at issue include [Redacted], a three member Idaho LLC, the entity which acquired the developed subdivision and sold the lots; [Redacted], a three member LLC, which was formed for the purpose of acquiring, developing, marketing, and selling the property; and [Redacted]'s successor, [Redacted], a two member Idaho LLC consisting of Mr. and Mrs. [Redacted], which continued on with the predecessor's business purpose of acquiring, developing, marketing, and selling real property.

On October 18, 2000, when the [Redacted] purchased [Redacted]'s 50 percent interest in [Redacted], [Redacted] is treated as having terminated under Internal Revenue Code section 708(b). [Redacted] is deemed to have transferred all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership, and immediately after that, [Redacted] is deemed to distribute interests in the new partnership to the [Redacted] in liquidation of [Redacted], either for the continuation of the business of the new partnership or for the dissolution and winding up. Treas. Reg. 1.708-1(b)(4). It is apparent, based upon the actions engaged in by the [Redacted], that the "new partnership" created for federal income tax purposes continued on with its predecessor's business purpose of acquiring, developing, marketing, and selling real property. Although [Redacted] was treated as a terminated partnership for federal income tax purposes, Idaho law does not necessarily treat the entity as having been terminated. The operating agreement was amended on October 24, 2004, to reflect the name change to [Redacted] and to record the change in members. The business purpose under the original operating agreement remained intact.

[Redacted], [Redacted] and [Redacted] under federal income tax law in effect at the time these partnerships owned the property at issue, would be treated as partnerships. IRC section 7701(a)(2) defines the term "partnership" to include any syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation. The regulations provide that for the purposes of IRC section 7701(a)(3) any unincorporated business entity that is not a publicly traded partnership covered by IRC section 7704 may elect whether or not to be classified as an association. Thus, an unincorporated business entity like an LLC can generally elect whether or not to be subject to the corporate tax. A default treatment applies under a variety of circumstances where a business entity chooses not to be considered a corporation. If an unincorporated business entity with more than one member elects not to be treated as an association, it will be treated for federal tax purposes as a partnership. If an unincorporated business entity with only one member elects not to be treated as an association, it will be treated for federal tax purposes as a disregarded entity and taxed as a sole proprietorship. Treas. Reg. section 301.7701-3(a).

In *C.I.R. v. Tower*, 327 U.S. 280, 290 (1946), the Court stated that "there can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner." In the formation documents for [Redacted], both Mr. [Redacted] and Mrs. [Redacted]individually acquired their own initial 25 percent interest in this entity. In affidavits submitted to an Idaho district court, both [Redacted] and [Redacted] stated that each of them supervised [Redacted], the development consultant, and made the business decisions for [Redacted] Therefore, under federal income tax law for determining entity classification for tax years 1999 through 2001, the period in which [Redacted] owned the property at issue, the husband-and-wife-owned [Redacted] would be treated as a separate legal entity classified as a partnership for federal income tax purposes.

As long as a bona fide business purpose existed for forming a separate entity to hold property, the existence of this separate entity will be honored for tax purposes. *Phelan v.*

Commr., T.C. Memo 2004-206, *Bramblett v. C.I.R.*, 960 F.2d 526, 533 (5th Cir. 1992). However, the courts have also taken into consideration the purpose for which a previous owner of the property held the property or disregarded the entity to which the property had been sold or transferred. For example, the Tax Court has held that the court may take into consideration the holding purpose of an entity that had liquidated and distributed its lots to its shareholders in deciding the purpose for which shareholders held the property. *Hancock v. Commissioner*, T.C. Memo. 1999-336; *see also Parkside. Inc. v. C.I.R.*, 571 F.2d 1092, 1096 (9th Cir.1977) (in deciding the purpose for which the taxpayer held property, the court considered the holding purpose of the taxpayer's shareholders' father, from whom the shareholders inherited the property. Additionally, where a partnership was found to have been engaged in a trade or business and its purpose was to develop real estate, the Ninth Circuit Court of Appeals determined that it was immaterial that the partnership sought to use another legally separate entity to achieve its commercial ends. *Estate of Freeland v. C.I.R.*, 393 F.2d 573, 582 (9th Cir., 1968) *cert. denied*, 393 U.S. 845 (1968). In the present case, the lots at issue were originally acquired by an entity ([Redacted]), developed by its predecessor ([Redacted]), which in turn sold the lots to another entity ([Redacted]) with [Redacted] being the entity formed for the purpose of selling the lots. Therefore, the Commission finds that the proper resolution of this protest requires that the Commission analyze the transactions at the partnership/entity level. Accordingly, the Commission will now turn its attention to determine the character of the gain on the sale of the property at the entity level.

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 Tax Court in *Phelan* made three factual inquiries: (1) whether the taxpayer was engaged in a trade or business, and, if so, what the business was; (2) whether the taxpayer was holding the property primarily for sale in that business; and (3) whether the sales contemplated by the taxpayer were ordinary in the course of that business.

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). The extent of development activity and improvements is an important factor in deciding whether a real estate activity is a trade or business. *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir.1980).

Whether property is "held by a taxpayer primarily for sale to customers in the ordinary course" of his trade or business is essentially a factual question. *Guardian Industries v. Commissioner*, 97 T.C. 308, 316 (1991). Over the years, various courts have considered a variety of factors in determining the taxpayer's primary purpose for holding property, including (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. *Wood v. Commissioner* T. C. Memo 2004-200. Many of the individual 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. v. United States*, supra at 177-179; *Hay v. Commissioner*, T.C. Memo.1992-409.

In 1993, Mr. [Redacted] and his employer [Redacted] formed the [Redacted] which was created for the business purpose of land development with the lots to be sold to customers in the ordinary course of its trade or business. The gain from the sale of the [Redacted] lots was treated by the partnership as ordinary income and reported by the [Redacted]on their individual income tax return as ordinary income. The development activity engaged in by the [Redacted] in developing the subdivision and in the selling of the lots as part of its trade or business was significantly less than the development activities engaged in by the entities that held the [Redacted] property.

In 1995 and 1996, the [Redacted] turned their attention to trying to acquire the [Redacted]property (5.4 acres) and the 48 plus acres owned by the [Redacted]. It took several years before the [Redacted] were ready to sell their property. In 1999, the [Redacted] partnered with [Redacted] to acquire the [Redacted] and [Redacted] undeveloped property, develop the land into residential lots, and sell the lots. More specifically, in June of 1999, the [Redacted] and [Redacted] entered into a "Memorandum of Understanding" to create a joint venture to "purchase, develop, hold, and sell the [Redacted]' property." Shortly thereafter, in July of 1999, the [Redacted] along with [Redacted] entered into a sales contract to purchase the [Redacted]' property. In September of 1999, [Redacted], [Redacted], and [Redacted] formed [Redacted] to "acquire, develop, and sell real estate." [Redacted] as the only managing member of [Redacted] retained control over the business decisions of the entity including the authority to authorize agents to act on behalf of [Redacted].

[Redacted] in February of 2000 entered into a sales contract to purchase the [Redacted] property and in April of 2000, filed its initial income tax return reflecting its principal business activity as land development and its product or service as land sales.

At some point in 2000, a decision was made to acquire [Redacted]'s interest in [Redacted] and to enter into a separate consulting agreement with [Redacted]'s president, [Redacted], to assist with the acquisition, development, marketing and sale of the [Redacted] and [Redacted] property. The [Redacted]successfully acquired [Redacted]'s interest in [Redacted] for $75,000 on October 18, 2000, and on October 24, 2000, entered into the consulting agreement with [Redacted]. As previously discussed, the acquisition of [Redacted]'s interest in [Redacted] resulted under federal income tax law as the termination of [Redacted], for which a final federal income tax return for tax year 2000 was filed, and the creation of a new partnership that became known as [Redacted]. At the time the consulting agreement with Mr. [Redacted] was executed, [Redacted], which was now owned in its entirety by the [Redacted], held the right to acquire the [Redacted] property; however, under the [Redacted], the right to acquire the [Redacted] property was still held by the [Redacted] and [Redacted]. On October 30, 2000, the [Redacted] and [Redacted] executed an amendment to the [Redacted] assigning the right to acquire the [Redacted] property to [Redacted].

From late 1999 through December of 2000, Mr. [Redacted] assisted with the development of the subdivision subject to the supervision and control of [Redacted] in their role as members of the [Redacted]. During the period July of 1999 through December 2000, [Redacted]. continued with the trade or business for which it was formed to acquire, develop, market, and sell the subdivision lots. In December of 2000, the [Redacted] after receiving comments back from contractors as a result of seeking bids for various infrastructure components, became unhappy with the work performed by Mr. [Redacted] [Redacted]. apparently terminated the contract with the initial engineer for the project and began looking for a way to terminate the consulting agreement with Mr. [Redacted]. The termination of the initial engineer and the attempts to terminate the consulting agreement resulted in two separate lawsuits. During the time the lawsuits were proceeding through the court process, from October of 2000 through December of 2001, [Redacted]. (1) acquired title to the [Redacted] property on January 4, 2001; (2) paid [Redacted], another development consultant, to assist with the development of the subdivision; (3), hired [Redacted], a real estate professional, on August 1, 2001, to market and sell the residential lots; (4) acquired title to the [Redacted] property on September 11, 2001; and (5) incurred over one million dollars ($1,000,000) for infrastructure costs (concrete, utilities, etc…), subdivision signs, landscaping costs, legal fees, accounting fees, etc. In December of 2001, in an apparent attempt to obtain capital gain treatment and to circumvent the payment of a 25 percent consulting fee under the Consulting Agreement with [Redacted], [Redacted] and the [Redacted] entered into a series of transactions resulting in the "sale" of the [Redacted] property to [Redacted]. [Redacted] was formed specifically for the purpose of selling the lots and, according to one of the petitioners' representatives, [Redacted] would be liquidated after the lots were sold. [Redacted] has since its inception used at least four different real estate agencies/professionals, including [Redacted]'s sister, to sell the lots.

In applying the aforementioned analysis of the IRC section 1221 character issue (ordinary versus capital) to the facts in this case at the entity level for either [Redacted] or [Redacted]., the Commission finds that the gain from the sale of the lots results in ordinary income. [Redacted] began selling the lots almost immediately after acquiring the land, never used the land for any other purpose, and continued this course of conduct over the last few years. In a letter dated

January 12, 2004, the petitioners' representative stated that "once the 41 lots were sold, [Redacted] would be liquidated and the proceeds distributed to the members."[15] Thus, the sales were not only ordinary; they were the sole object of [Redacted]'s business. The result is the same if the analysis is done at [Redacted]'s level. [Redacted] continued on as a two member LLC, treated as a partnership under federal law, with the business purpose of acquiring, developing, marketing, and selling the property and simply used [Redacted] to achieve its commercial end. During the April 14, 2002, deposition, Mr. [Redacted] acknowledged that [Redacted] was formed at the end of 2001 in an attempt to obtain capital gain treatment since <u>he would only have received ordinary income treatment under the ownership structure prior to the creation of</u> [Redacted].

IRC section 1221, the statute according preferential treatment to capital gains, is to be construed narrowly "so as to protect the revenue against artful devices." *Commissioner v. Lake*, 356 U.S. 260, 265 (1958). *See also Corn Products Refining Company v. Commissioner*, 350 U.S. 46, 52 (1955); *Omer v. United States*, 329 F.2d 393, 395 (6th Cir. 1964); *Cline v. Commissioner*, 617 F.2d 192 (6th Cir. 1980). Furthermore, the petitioners have the burden of proving that the Commission's classification of the proceeds of the sale as ordinary income is erroneous. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Mathews v. Commissioner*, 315 F.2d 101, 106 (6th Cir. 1963). Given the facts in this case, the Commission finds that the petitioners have not met their burden of showing that the sale of the [Redacted] should be afforded capital gain treatment.

Other Issues

[15] Letter from [Redacted]'s representative[Redacted], dated January 12, 2004.

Holding Period

Another issue raised in the petition for redetermination was the holding period for the lots sold in 2002. For tax year 2002, in order for the gain on the sale of Idaho real property to qualify for the Idaho capital gains deduction, the real property must have been held for 18 months. Idaho Code section 63-3022H (3)(a). The lots at issue in 2002 were lots that had been part of the [Redacted] property.[16] Although title to the [Redacted]property was not conveyed to [Redacted] until September 11, 2001, the representative argues that since the buyers had paid $350,000, the Contract of Sale was an "installment sale land contract which works as an equitable conversion of the land" thereby providing the buyers with equitable ownership in the land as early as July 1999 but no later than July of 2000. The Commission finds the argument rather surprising given that documents submitted by the petitioners to an Idaho District Court claimed that [Redacted] purchased the [Redacted] on December 28, 2001, for approximately three million dollars. Even if the sale was not treated as a valid transaction, the language of the Contract of Sale does not support the petitioners' position given that

- Under Sections 2 and 6 of the Sales Contract, as amended in April of 2000, the buyers had the right to terminate the contract up until October 1, 2000, and if so terminated, the buyer's would only lose the $50,000 earnest money but not the $300,000 down payment.
- If the sale did not occur by the closing date, which per the April of 2000 amendment was to occur by July 1, 2001, the buyers' right to purchase the property may be terminated and the earnest money retained by the [Redacted].

[16] [Redacted]'s representative's letter dated October 2, 2003, page 2.

- As of July of 2000, the buyers had actually only paid the $50,000 earnest money and the additional payment of $300,000 was not due until closing, at which time it was to have been paid to an escrow agent. On December 29, 2000, the [Redacted]'s did make a $300,000 payment directly to the [Redacted]; however, it would appear that had the sale not happened, the [Redacted] under Section 9 of the Sales Contract would have been entitled to the return of the $300,000 payment.

Since the Commission has found that the sale of the lots generated ordinary income rather than capital gain, the Commission need not decide, as part of this Decision, the Idaho Code section 63-3022H holding period issue.

<u>Basis in Lots Sold</u>

During the course of the redetermination, it was discovered that the $300,000 down payment made in December of 2000 had been included twice in the calculation of the basis of the subdivision lots. Additionally, in a letter dated September 23, 2005, the petitioner acknowledged that certain "other development and operating costs" should have been handled differently than had been as reported in the return as filed. As such, the NODD issued by the Bureau to [Redacted][Redacted] dated November 10, 2003, has been modified to correct for these errors and reflect that the gain on the sale of the property is not $474,579 as reported in the Notice of Deficiency Determination but rather $696,647 calculated as follows:

Lot	Block	Date Sold	Sales Price	Cost[17]	Gain
4	5	06/19/02	$130,600	$58,756	$71,844
2	6	06/26/02	$149,900	$60,056	$89,844
3	6	04/19/02	$139,900	$59,061	$80,839
2	8	02/20/02	$115,000	$46,816	$68,184
3	8	05/24/02	$131,900	$58,501	$73,399

[17] See attached Appendix B for recalculation of the basis in the property sold.

4	8	08/16/02	$131,900	$59,518	$72,382
5	8	08/09/02	$150,000	$66,675	$83,325
6	8	02/21/02	$150,000	$60,605	$89,395
7	8	12/23/02	$165,000	$97,565	$67,435
12	6	06/28/02	$0	$0	$0
Totals			$1,264,200	$567,553	$696,647

Phase-out Limitations for Itemized Deductions and Personal Exemptions

Included in the redetermination of the monies due from the [Redacted]as a result of the reclassification of the gain on the sale of the lots from capital to ordinary is the impact, if any, the re-characterization of the income from capital to ordinary had on the allowable deductions for itemized deductions and personal exemptions.

WHEREFORE, the Notice of Deficiency Determination issued to [Redacted] dated November 10, 2003, is hereby MODIFIED and, as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

WHEREFORE, the Notice of Deficiency Determination issued to [Redacted] dated November 10, 2003, is hereby MODIFIED and, as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that [Redacted] pay the following tax and interest:

YEAR	TAX	INTEREST	TOTAL
2002	$41,872	$7,239	$49,111

Interest is calculated through April 15, 2006, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

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

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

DATED this ____ day of ___________________, 2006.

IDAHO STATE TAX COMMISSION

____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _______________, 2006, 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]
[Redacted]
[Redacted]

____

[Redacted]

[Redacted]	[Redacted]
[Redacted]	[Redacted]
[Redacted]	[Redacted]
[Redacted]	[Redacted]

a. [Redacted]

	[Redacted]	[Redacted]	[Redacted]	[Redacted]
				[Redacted]
	[Redacted]	[Redacted]	[Redacted]	[Redacted]
	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]		[Redacted]		
[Redacted]		[Redacted]	[Redacted]	
[Redacted]	[Redacted]			
[Redacted]	[Redacted]			
[Redacted]			[Redacted]	
[Redacted]			[Redacted]	
[Redacted]			[Redacted]	
[Redacted]			[Redacted]	
[Redacted]	[Redacted]			
[Redacted]	[Redacted]			
[Redacted]				[Redacted]
[Redacted]	[Redacted]			
[Redacted]				[Redacted]
[Redacted]			[Redacted]	
[Redacted]	[Redacted]			
[Redacted]	[Redacted]			
[Redacted]	[Redacted]			
[Redacted]			[Redacted]	
[Redacted]	[Redacted]			
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]

b. [Redacted]

	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]

c. [Redacted]

[Redacted]	[Redacted]	[Redacted]	[Redacted]

[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]		[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]

[Redacted]