

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 20180
[Redacted],)	
)	DECISION
Petitioner.)	
_____)	

[Redacted] (Petitioner) protests the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated February 27, 2007, regarding the calendar years of 2003 and 2004. The Notice of Deficiency asserted no additional amount due by the petitioner since the income adjustments are to be reflected on the returns of the members of the petitioner.

The auditor made several adjustments to the income reported by the petitioner:

1. Income was reclassified from capital gain to ordinary income in the amount of \$100,377 and \$791,613 for 2003 and 2004, respectively;
2. The basis of lots sold was decreased in the amount of \$35,413 for 2003; and
3. Income from purported like-kind exchanges was increased by \$263,238 and \$489,628 for 2003 and 2004, respectively, denying like-kind treatment.

FACTS AND PROCEDURAL HISTORY

[Redacted] was created on December 4, 2001, as an Idaho Limited Liability Company. 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.”¹ [Redacted] elected to be treated as a partnership for federal income tax purposes and filed federal partnership returns for 2002-2004. [Redacted]’s members and the members’ interests for 2003 and 2004 were as follows:

¹ [Redacted]

Member Name	Profit/loss Sharing Percentage	Ownership of Capital Percentage
[Redacted]	50%	45%
[Redacted]	50%	45%
[Redacted]	0%	10%

[Redacted] was the successor in interest to other entities which had purchased parcels of real estate and had set about to subdivide and sell the property. In the Commission's decision for docket numbers 17852 and 17858, the Commission found that the petitioner had not met its burden of showing that the sale of the lots should be afforded capital gain treatment. The Commission's decision for those dockets was not appealed. The auditor relied upon this prior ruling as a basis for disallowing the capital gain treatment for all of the subdivided property.

LAW AND ANALYSIS

The determination of whether the gain should be characterized as ordinary or capital gain income must be made by determining the character of the gain at the entity level. Phelan v. Commissioner, T.C. Memo 2004-206; Podell v. Commissioner, 55 T.C. 429, 433 (1970).

If 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). Therefore, it is important that the history of the purchase and subsequent transfers of the property in question be understood. Some of the details of the history of the acquisition, development, and selling of the land in question are set out in the Appendix of this decision.

The petitioner contends that the gain from the sale or disposition of the subdivided lots should be characterized as capital gain. The auditor contends that this gain should be considered to be ordinary income. This determination is important for Idaho income tax purposes for two

reasons. The first is that if the gain from the disposition of the property is characterized as ordinary income, then the disposition of the property does not qualify for treatment pursuant to Internal Revenue Code § 1031 as a like-kind exchange. Secondly, if the gain from the disposition results in ordinary income, the Idaho capital gains deduction is not applicable.

The issue to be resolved is whether the gain in question was from “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.”

Internal Revenue Code § 1221 provides, in pertinent part:

Capital asset defined.

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; (Underlining added.)

The underlined portion above sets out two questions that need to be addressed: (1) did the activity of the taxpayer rise to the level of a “trade or business,” and (2) if so, was the property in question held primarily for sale in that “trade or business.”

Did the activities of [Redacted] and its predecessors constitute a trade or business? In Howell, et al. v. Commissioner, 57 T.C. 546 (1972), the government asserted that, since the only activity that the corporation had was the purchase of real property with the intent to eventually sell the property at a profit, this activity must have resulted in the receipt of ordinary income. The Court disagreed and stated that, “[t]here is nothing unique or improper about a corporation engaging in exclusively investment activity.” In this docket, as in Howell, the petitioner had only one activity, this being the purchase, subdivision, development, and sale of real property.

The first purchase agreement with regard to the property at issue in this matter was executed on July 27, 1999. The agreement set out that there was a period of a year during which the agreement was voidable if the desired zoning was not obtained. On August 5, 1999, an engineer began providing engineering services for the project. After the sellers had granted an easement across the property, an attorney for the buyers in a letter dated January 14, 2000, indicated that the easement would be “rendering what would otherwise be rim lots virtually unsaleable².” The letter also indicated that a preliminary plat had been submitted and approved by the Ada County Highway District and that the City of Eagle had the annexation of the property on its agenda.

From the brisk pace of these events and many more, it seems clear that the intent from the beginning was to subdivide the property and to sell it. A review of the extensive chronology of events regarding the property shows what appears to be a singleness of purpose with regard to the property, i.e., to develop, subdivide, and sell it. It seems clear that the property was held by the petitioner primarily for sale to customers at all times.

In Suburban Realty Company v. United States, the Fifth Circuit Court of Appeals stated, in part:

In the principal recent cases, there has always been a conjunction of frequent and substantial sales with development activity relating to the properties in dispute. See, e. g., Houston Endowment, Inc. v. United States, 606 F.2d 77, 82 (5th Cir. 1979), Biedenharn, 526 F.2d at 417; United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969). The conjunction of these two factors “will usually conclude the capital gains issue against (the) taxpayer.” Biedenharn, 526 F.2d at 418. Judge Wisdom has recently written that “ordinary income tax rates usually apply when dispositions of subdivided property over a period of time are continuous and substantial rather than few and isolated.” Houston Endowment, 606 F.2d at 81. Also, it has been explicitly stated that the factor which will receive greatest emphasis is frequency and substantiality of sales over an extended time period. See Biedenharn, 526 F.2d at 417.

² [Redacted]’ letter dated January 14, 2000, page 1.

Suburban Realty Company v. United States, 615 F.2d 171, 176 (5th Cir. 1980).

In Harder v. Commissioner, T.C. Memo 1990-371, the court set out seven criteria to be considered in determining whether property is held for sale to customers in the ordinary course of the taxpayer's trade or business:

As respondent points out on brief, this Court has used several factors in order to make this determination:

(1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.' [McManus v. Commissioner, 65 T.C. at 211, quoting from United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969).]

In Harder, the parcel was improved by the plaintiff by subdividing the land, having the property annexed, preparing a tract map, and installing curbs, gutters, sidewalks, streets, and utilities. They also hired a sales agent. The court held that the income from the sale of the subdivided property constituted ordinary income.

In Bynum v. Commissioner, 46 T.C. 295 (1966), the landowners subdivided and had 38 lots available for sale. They had made improvements including streets, curbs, gutters, drainage, and utilities. The court found that the gain from the sale of the lots was ordinary income.

In Gates v. Commissioner, 52 T.C. 898 (1969) Mrs. Gates sold her first lot from her "Southgate Addition" some six months after the purchase. Substantial (unspecified) improvements had been made to the property which was divided into 46 lots. She apparently held no other real estate. The court deemed the gain from the sale of lots to be ordinary income.

In Lewellen v. Commissioner, T.C. Memo 1981-581, 31 lots had been sold over a 12 year period. In holding that the sales produced ordinary income, the Tax Court stated, in part:

Such continuous and substantial sale of lots over a long period of time strongly suggests that the lots were held primarily for sale to customers in the ordinary course of business. Further, we do not believe petitioner's contention that he was following a course of liquidation in view of the substantial improvements made to the land for landscaping, the installation of utilities, the costs incurred for engineering and the extensive road construction, all completed prior to the sale of lots.

In its prior decision, the Commission ruled that the gains from these activities were not eligible for capital gain treatment. After reviewing the information in the file, the Commission finds little evidence of any change in the nature or extent of the activities of the petitioner. Accordingly, the Commission finds in this docket as well that the dispositions of the subdivided property produced ordinary income for the petitioner.

LIKE-KIND EXCHANGES

The auditor disallowed like-kind treatment for the petitioner's exchanges and accordingly treated the exchanges as sales and purchases of the respective properties. He held that the purported like-kind exchanges did not qualify because the property given up in the exchange was property held for sale in the ordinary course of the petitioner's business.

In examining the information in the file, it appears that there are other concerns with regard to whether the exchanges in question qualified for treatment pursuant to Internal Revenue Code § 1031. These include the following:

1. There is no showing that the property received was used in a trade or business or for investment,
2. It appears that the property received was a leasehold interest and not like-kind with the fee simple interests in the realty given up, and
3. It appears that the property received was taken in the name of [Redacted] and not by the petitioner.

Internal Revenue Code § 1001(c) generally requires that gain or loss is to be recognized from the sale or other disposition of property. However, Internal Revenue Code § 1031(a)(1) provides an exception to this rule for “property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.” Specifically excepted from treatment pursuant to this verbiage is “stock in trade or other property held primarily for sale” (IRC § 1031(a)(2)(A)) and “interests in a partnership” (IRC § 1031(a)(2)(D)). The burden of proving that the disposition of the petitioner’s property qualifies as a like-kind exchange under section 1031 is on the petitioner. Welch v. Helvering, 290 U.S. 111 (1933).

As was set out above, the Commission finds that the property disposed of by the petitioner was held primarily for sale. Therefore, this disqualifies the property from being eligible for treatment pursuant to Internal Revenue Code § 1031.

Internal Revenue Code § 1031 requires that the property must be, “held for productive use in a trade or business or for investment.” The properties received in the purported exchanges were residential properties near [Redacted]. There is nothing in the file to indicate that the properties were rented or were otherwise used for business purposes. See Moore v. Commissioner, T.C. Memo 2007-134. Therefore, the Commission finds that the petitioner has not met its burden in this respect.

The purported exchanges were reflected on the petitioner’s income tax returns. Therefore, presumably, the property relinquished was property held by the petitioner. It appears from the information in the file that the replacement property was taken in the names of [Redacted], not in the name of the petitioner. The only interest that the [Redacted] held in the real property given up was as a part of their partnership interest in [Redacted]. Therefore, it appears that the property given up was a part of their partnership interest and specifically does not qualify for treatment

pursuant to Internal Revenue Code § 1031(a)(2)(D). Since [Redacted] apparently received nothing in return for the property given up, it does not qualify as a like-kind exchange by [Redacted]. See Chase v. Commissioner, 92 T.C. 874 (1989).

In examining the nature of the replacement properties, we find that both such properties were located on land owned by the state of Idaho and that the property was leased to others. It appears that the term of the lease is no more than ten years. Regulation § 1.1031(a)-1(c) provides that leases with a term of 30 years or more will be deemed to be of like-kind with fee simple interests in realty. Since the ten year term is far short of the 30 year term required, it appears that the replacement property does not qualify for treatment pursuant to Internal Revenue Code § 1031.

Since there are several questions of fact which are unresolved and the burden of proof rests upon the petitioner, the Commission finds that the petitioner has not carried its burden of proof with regard to this issue. Therefore, the auditor's treatment is affirmed.

In summary, the Commission finds that the petitioner has not demonstrated either that the properties relinquished or the properties received in the purported like-kind exchanges qualified for treatment pursuant to Internal Revenue Code § 1031. Therefore, the auditor's position regarding the purported exchanges is affirmed.

WHEREFORE, the Notice of Deficiency Determination dated February 27, 2007, is hereby APPROVED, AFFIRMED, AND MADE FINAL.

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

DATED this ___ day of _____, 2008.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2008, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

**APPENDIX
HISTORY of [Redacted]**

[Redacted]³[Redacted]⁴[Redacted]

³ Page 1 of original “Contract of Sale” executed in July of 1999.

⁴ *Id.*