BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 22614
[Redacted],	)	
	)	
Petitioners.	)	DECISION
	)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated October 29, 2009, asserting an additional liability for Idaho income tax, penalty, and interest in the total amount of $15,892 for 2005.

The sole issue to be decided is whether the exchange of interests in real property held through a partnership interest and a beneficial interest in a trust are eligible for a like-kind exchange for real property pursuant to Internal Revenue Code (IRC) § 1031.

The petitioners held both a partnership interest and a beneficial interest in a trust. Both the partnership and the trust held interests in real property. The petitioners disposed of their interest in both the partnership and the trust. Their instructions were that the proceeds they received from the disposition of these interests were to be conveyed to a facilitator for the completion of a like-kind exchange into real property pursuant to IRC § 1031.

The auditor contests the treatment of the transaction as a like-kind exchange contending that the petitioners did not convey real property in exchange for real property they received. He therefore contends that the gain from the disposition of the interests in the partnership and in the trust were taxable.

The petitioners concede that the title to the underlying property was never recorded in their names. They argue that the substance of the transaction was that they conveyed their interest in the real property held by the partnership and by the trust in exchange for real property held directly by them and that the substance of the transaction should prevail over the form of the transaction, thereby allowing them treatment pursuant to IRC § 1031. The petitioners contend that they held themselves out as owners, that the sales documents list them as sellers, that they paid their share of the closing costs, and that the funds were transferred at their direction.

What is missing from the material submitted by the petitioners is any documentation that the real property disposed of was, at any time, owned directly by the petitioners. No deed was submitted. The information in the file does not include any document showing that the deed to the property disposed of was, at any time, conveyed to the petitioners. The petitioners wish to characterize the interests they gave up in the transactions as having been something other than a partnership interest and a beneficial interest in a trust. However, the evidence in the file fails to establish any other character of the interests in the property in question.

IRC § 1031 stated, in part:

> Exchange of property held for productive use or investment.
> (a) Nonrecognition of gain or loss from exchanges solely in kind.
>> (1) In general. No gain or loss shall be recognized on the exchange of 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.
>> (2) Exception. This subsection shall not apply to any exchange of—
>>> (A) stock in trade or other property held primarily for sale,
>>> (B) stocks, bonds, or notes,
>>> (C) other securities or evidences of indebtedness or interest,
>>> (D) <u>interests in a partnership</u>,
>>> (E) <u>certificates of trust or beneficial interests</u>, or
>>> (F) choses in action.
>>
>> (Underlining added.)

The clear language of the law precludes both the interest in the partnership and the beneficial interest in a trust from treatment pursuant to IRC § 1031.

The petitioners contend that the substance of the transactions should govern rather than the form of the transactions. They cite several cases in support of their position. They specifically cite from the U.S. Tax Court:

> In making this determination, the steps taken to accomplish the end result must be considered as well as the result itself. The substance of the transaction, rather than its form, must govern the tax consequences. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935); Biggs v. Commissioner, 69 T.C. 905 (1978), affd. 632 F.2d 1171 (5th Cir. 1980); Barker v. Commissioner, 74 T.C. 555 (1980).
>
> The parties' intent often has been considered in evaluating the true substance of a purported exchange transaction. Intent alone does not determine tax consequences, and the bare fact that a taxpayer desires to fall within a particular section of the Internal Revenue Code is not controlling where actions belie expressed intent. See Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976); Carlton v. United States, 385 F.2d 238 (5th Cir. 1967). Nonetheless, stated intent has received deference where parties have acted consistently therewith.
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> Garcia v. Commissioner, 80 T.C. 491, 497-498 (1983).

The petitioners have failed to cite any case in which a court approved a partnership interest or a beneficial interest in a trust being exchanged for real property pursuant to IRC § 1031. The petitioners contend that the substance of the transactions (as opposed to the form) was that their interests in the real property (held by the partnership and the trust) were exchanged for the replacement real property. Their argument is that this “substance” should cause the partnership interest and the beneficial interest to qualify for treatment pursuant to IRC § 1031 which specifically precluded (since 1984) these interests from qualifying.

In addressing a substance versus form argument asserted by the taxpayer, the U.S. Tax Court stated, in part:

> We have observed that “‘the taxpayer may have less freedom than the Commissioner to ignore the transactional form that he has adopted.’ “ Ill. Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986) (quoting Bolger v. Commissioner, 59 T.C. 760, 767 n. 4 (1973)). In applying the substance over

form doctrine, we are concerned with the intentions of the parties at the time of the transaction. Groetzinger v. Commissioner, 87 T.C. 533, 542 (1986).

To prevail, the taxpayer must provide objective evidence that the substance of the transaction is in accord with the position argued by the taxpayer rather than the form set forth by the relevant documents. Id. at 541. Furthermore, for substance, as opposed to form, to control the tax consequences of a transaction, the taxpayer must establish the claimed substance of the transaction under a heightened burden of proof. Norwest Corp. v. Commissioner, 111 T.C. 105, 140, 145 (1998); Ill. Power Co. v. Commissioner, supra at 1434. The strong proof standard requires the taxpayer to present more than a preponderance of the evidence in support of his characterization of the transaction. Ill. Power Co. v. Commissioner, supra at 1434 n. 15.

Petitioners argue that although the [Redacted] lot was purchased by the Family Partnership, the partnership was never fully implemented, and therefore, it should be disregarded. However, petitioners stipulated that the Family Partnership was formed. They stipulated that the partners were petitioners and two of their children, and that the partnership purchased the [Redacted] lot.

Petitioners argue that because their children did not sign the partnership agreement, contribute to the partnership, and that the partnership did not register with the state or receive an employee identification number, the partnership was not fully implemented. In determining whether a partnership exists under Maryland law, the controlling factor is the intent of the partners to create a partnership. Cohen v. Orlove, 57 A.2d 810, 812 (Md.1948). Petitioners admit they intended to form a partnership to insulate the property from attachment by judgment creditors. Their minor children were central to that goal because petitioners believed partial ownership by the children would make the property less susceptible to attachment by judgment creditors.

Although petitioners' children did not make contributions to the partnership, partnerships that are created by gift may be recognized for Federal tax purposes. See sec. 704(e); sec. 1.704-1(e), Income Tax Regs. That the partnership never registered with the State of Maryland, nor obtained an employee identification number is not dispositive.

At all relevant times, petitioners represented that the property was held by the Family Partnership. It was not until receipt of the notice of deficiency that they began to hold themselves out as the owners of the property. Therefore, we hold that petitioners have failed to meet their burden of proving that the Family Partnership was not fully implemented and should be disregarded.

Petitioners argue alternatively that the Family Partnership distributed the property to them in 1992. In support of their position, petitioners introduced into evidence a document purporting to assign the property to petitioners as tenants by the entirety. The document is not a deed. The purported transfer was not recorded, and thus record title to the [Redacted] lot remained with the Family Partnership until its sale in 2001. The property was never titled in petitioners' names. Therefore, property tax bills always listed the owner of the property as the Family Partnership. Similarly, the listing agreement and the form HUD-1 settlement sheet listed the owner as the Family Partnership, not petitioners.

Petitioners argue that the property was transferred to themselves to facilitate a refinancing of the [Redacted] because the lender required the property be held by petitioners individually. However, the record indicates that after petitioners used the proceeds of the refinancing to pay off the respective purchase loans, there was no longer a mortgage on the [Redacted] lot; the only mortgage was on the [Redacted] house. Furthermore, it is unlikely a lender would require a change in ownership, but not require that the change be reflected by recordation of a deed of transfer.

Maryland law recognizes that ownership of property may be, either formally or informally, separated from title to property. Vlamis v. De Weese, 140 A.2d 665 (Md.1958). However, we cannot treat lightly the formal manner in which property is held, lest we subject legal titles to unnecessary uncertainties and complicate the administration of law. Estate of Rosenblatt v. Commissioner, T.C. Memo.1977-12.

Petitioners had approximately 10 years in which to record the change in ownership of the South Point Road lot, but they did not. Petitioners contend they had been the owners of the lot since 1992. However, when selling the property they listed the Family Partnership as its owner. It was not until petitioners realized ownership of the property through the Family Partnership produced adverse tax consequences that they held themselves out as the owners of the property. Petitioners were free to organize their affairs as they chose; nevertheless, having done so, they must accept the tax consequences of their choices, whether contemplated or not. See Commissioner v. Natl. Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974).

For the foregoing reasons, we hold that petitioners have failed to meet their burden of proving they were the owners of the [Redacted] lot. As they did not own the [Redacted] lot, petitioners are not entitled to exclude the gain on its sale under section 121. [footnote omitted.] Allied Marine Sys., Inc. v. Commissioner, T.C. Memo.1997-101, affd. without published opinion sub nom. Gibbons v. Commissioner, 155 F.3d 558 (4th Cir. 1998).

Farah v. Commissioner, T. C. Memo 2007-369.

In addressing the extent in which the taxpayer's intent affected the proper tax treatment, the Fifth Circuit Court of Appeals stated, in part:

> The appellants' intention and desire to execute an exchange does not alter the reality and substance of the situation. It is well established that the intention of a taxpayer to avail himself of the advantages of a particular provision of the tax laws does not determine the tax consequences of his action, C.I.R. v. Duberstein, 363 U.S. 278, 286, 80 S.Ct. 1190, 4 L.Ed.2d 1218, 1225 (1960), but what was actually done is determinative of the tax treatment. Weiss v. Stearn, 265 U.S. 242, 44 S.Ct. 490, 68 L.Ed. 1001 (1924). Thus, the intention of the appellants to effect an exchange does not convert the transfer of property for cash into an exchange.

Carlton v. United States, 385 F.2d 238, 243 (5th Cir. 1967).

Whether the petitioners could invoke IRC § 1031 to escape recognition of a gain on an exchange of "like kind" real properties is a question of tax mitigation, provided by legislative grace, and falls within the burden of proof rules applicable to disputed deductions. Rockwell v. Commissioner, 512 F.2d 882, 886 (9th Cir. 1975).

In addressing the burden of proof for income tax deductions, the Idaho Supreme Court stated:

> The Stangs urge this Court to "construe" the Idaho Income Tax Code in a manner that would permit the Stangs to avoid paying Idaho income tax on the $8,000 distribution. They argue that because the Idaho Income Tax Code does not expressly address this situation, this Court should be free to construe the tax code in a manner that would prevent the Stangs from having to pay taxes to both California and Idaho on the same monies. When construing the provisions of the Idaho Income Tax Code, however, we must enforce the law as written. Potlatch Corp. v. Idaho State Tax Comm'n, 128 Idaho 387, 913 P.2d 1157 (1996). If there is any ambiguity in the law concerning tax deductions, the law is to be construed strongly against the taxpayer. Id. This Court has no authority to rewrite the tax code. Bogner v. State Dep't of Revenue and Taxation, 107 Idaho 854, 693 P.2d 1056 (1984). Any exemption from taxation must be created or conferred in clear and plain language and cannot be made out by inference or implication. Herndon v. West, 87 Idaho 335, 393 P.2d 35 (1964). This Court does not have the authority to create deductions, exemptions, or tax credits. If the provisions of the tax code are socially or economically unsound, the power to correct it is legislative, not judicial. Id.

Idaho State Tax Commission v. Stang, 135 Idaho 800, 802-803 (2001).

We conclude that the petitioners have failed to carry their burden in showing that they, not the partnership and the trust, owned the real property in question. We further conclude that the interests given up by the petitioners were those specifically precluded from treatment pursuant to IRC § 1031 and that this is not overcome through the petitioners' substance versus form argument.

WHEREFORE, the Notice of Deficiency Determination dated October 29, 2009, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax, penalty, and interest (computed to November 30, 2010):

YEAR	TAX	PENALTY	INTEREST	TOTAL
2005	$12,390	$ 620	$3,452	$16,462

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.

DATED this ________ day of ___________________ 2010.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of __________________ 2010, 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.

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