

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NOS. 22797 & 22798
[Redacted],	)	
	)	
Petitioners.	)	DECISION
	)	
	)	
_____	)	

[Redacted], a n S c orporation w holly o wned b y [Redacted], protest t he N otices o f Deficiency Det ermination ( NODD) issue d by the sta ff of the Idaho State Tax Commi ssion (Commission) date d Ja nuary 20, 2010. The Not ice of Defi ciency Det ermination issued to [Redacted] asserted no liability since the adjustments flow through to the shareholders. The NODD issued to [ Redacted] asserted a dditional liability for Id aho income tax and in terest in the total amounts of \$1,625 and \$4,328 for 2006 and 2008, respectively.

The sole contested issue is whether the petiti oners are entitled to an investment tax credit (ITC) on a [Redacted] w as rented from May 20 07 to D ecember 2007 and then purchased, t he petitioners are not entitled to the ITC.

**FINDINGS OF FACT**

- [Redacted] 2. On June 22, 2007, an employee of [Redacted] signed a document entitled “EQUIPMENT RENTAL AGREEMENT<sup>1</sup>.” It reflected, in part, the following provisions:
- a. Monthly rental payments in the amount of \$10,500.
  - b. The rental term was to begin on May 29, 2007, with no ending date for the rental.
  - b. Provision for [Redacted] to elect to purchase the [Redacted].

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<sup>1</sup> The petitioners stated that they were not aware of this document until it was produced pursuant to a summons issued to [Redacted].

c. "Construction: This is an agreement for rental only. Nothing herein will be construed as conveying to Lessee any right, title or interest in or to the Equipment, except as a lessee."

d. "Guaranteed Rental – Return of Equipment: Provided the guaranteed rental set forth on the reverse side is or has been paid, Lessee may return the Equipment and terminate the rental term hereunder on three days [sic] notice to Lessor."

3. On November 14, 2007, [Redacted] prepared a "Rental Conversion" statement. It reflected the rental payments through October 16, 2007, noting that the November 16, 2007, invoice had not been paid. It noted "Convert. Amt. At the End of Rental Period."

4. A "[Redacted]" was signed by [Redacted] on December 24, 2007. This document reflected a purchase price of \$273,000 with rent applied in the amount of \$45,213.45 and sales tax in the amount of \$13,721.18 for a net purchase price of \$242,407.73.

5. On December 28, 2007, [Redacted]. filed a Financing Statement identifying, in part, the [Redacted] system which had been installed on the [Redacted]. It appears that this was the first time that a Financing Statement had been filed by a creditor with regard to [Redacted] system.

6. [Redacted] issued a "Rental Invoice" to [Redacted]. On each of these invoices for rental, sales tax was imposed.

7. [Redacted] deducted the rental payments as "lease expense" on its 2007 income tax return.

8. [Redacted] did not depreciate the [Redacted] on its 2007 income tax return. It first depreciated the [Redacted] on its 2008 income tax return.

9. [Redacted] claimed the Idaho investment tax credit with regard to the [Redacted] on its 2008 Idaho income tax return.

## DISCUSSION

The Commission finds that the auditor's position should be affirmed.

Idaho Code § 63-3029B provides for a credit for certain capital investments. It stated (2007), in pertinent part:

**Income tax credit for capital investment.** (1) At the election of the taxpayer there shall be allowed, subject to the applicable limitations provided herein as a credit against the income tax imposed by chapter 30, title 63, Idaho Code, an amount equal to the sum of:

- (a) The tax credit carryovers; and
  - (b) The tax credit for the taxable year.
- (2) The maximum allowable amount of the credit for the current taxable year shall be three percent (3 %) of the amount of qualified investments made during the taxable year.
- (3) As used in this section "qualified investment" means certain property which:
- (a) (i) Is eligible for the federal investment tax credit, as defined in sections 46(c) and 48 of the Internal Revenue Code subject to the limitations provided for certain regulated companies in section 46(f) of the Internal Revenue Code and is not a motor vehicle under eight thousand (8,000) pounds gross weight;

\* \* \*

(11) Only for the purposes of subsections (3)(a) and (8) of this section, references to sections of the "Internal Revenue Code" mean the sections referred to as they existed in the Internal Revenue Code of 1986 prior to November 5, 1990.

Internal Revenue Code § 48(b) stated (1990), in part:

New section 38 property. For purposes of this subpart –

- (1) In general. The term "new section 38 property" means section 38 property the original use of which commences with the taxpayer.

Internal Revenue Code § 48 (c) stated (1990), in part:

Used section 38 property.

- (1) In general. For purposes of this subpart, the term "used section 38 property" means section 38 property acquired by purchase after December 31 1961. which is not new section 38 property. Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or be a person who bears a relationship

described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition). (Underlining added.)

The auditor's position is that the original "user" was the implement dealer or [Redacted] as the lessor of an asset leased to [Redacted]. Therefore, the original use was by the lessor, and when the [Redacted], they had previously used the machinery, therefore IRC § 48(c)(1) precluded the property from qualifying as "used section 38 property" and, therefore, it does not qualify for the Idaho investment tax credit. The information in the file indicates that the [Redacted] "[Redacted]" for the petitioners on or about May 28, 2007<sup>2</sup>. Therefore, the specific question to be resolved is whether there was an enforceable contract of sale in place by this date.

The petitioners contend that Administrative Rule 711.04.b is controlling in this matter. It states:

If a taxpayer is a lessee in a conditional sales contract, he is entitled to investment tax credit on any qualifying property subject to the contract since the lessee is considered the purchaser of the property.

The petitioners contend that they purchased the [Redacted] in question through a conditional sales contract some time in 2007. They point to the quote issued by [Redacted] which was apparently issued to the petitioners on March 22, 2007, and updated on August 2, 2007.

It is not uncommon for the distinction between a lease and a conditional sales contract to be in dispute. The Tax Court addressed such a situation, in part, as follows:

There are numerous cases involving the question of whether a purported lease is to be recharacterized as a conditional sale. Many different factors have been identified and relied upon in resolving this question. See Simonson, Determining Tax Ownership of Leased Property, 38 Tax Lawyer 1 (1984). Without undertaking exhaustive analysis of the case law, two clear points appear. First, if the nominal lessor 'retains significant and genuine attributes of traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.' Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978). However, if the benefits, obligations,

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<sup>2</sup> See letter from [Redacted] dated May 27, 2010.

and rights of the putative lessor are essentially those of a secured seller, the substance of the arrangement must govern and it will be deemed a sale for tax purposes. Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir, 1982), revg. 76 T.C. 547 (1981); [footnote omitted] Smith v. Commissioner, 51 T. C. 429, 438-439 (1968).

In many cases, the dividing line between a sale and a lease is murky and difficult to discern. In this case, however, the determination rests upon the proper construction of the agreement between Stanislaus and J & W by which J & W obtained possession and use of the airplane. Many of the risks and burdens of ownership (insurance, operating expenses, and taxes) were passed to J & W through the purported 'net lease.' Similarly, J & W's purchase 'option' gave it a significant benefit of ownership--the right to whatever value the airplane possessed at the end of the agreement in excess of the option price. The option price was the unpaid loan balance of the purchase money indebtedness on the airplane incurred by H & H, Stanislaus' predecessor in interest. That option price, under a normal loan amortization, should have been approximately \$180,000 at the end of the lease period.

Neither the 'net lease' nor the 'lease's' purchase option necessarily mandates the conclusion that the agreement was really a sale. See Frank Lyon Co. v. United States, supra, 435 U.S. at 567; LTV Corp. v. Commissioner, 63 T.C. 39, 49- 50 (1974); Northeast Acceptance Corp. v. Commissioner, 58 T.C. 836, 847- 848 (1972), affd. per curiam 500 F.2d 1222 (9th Cir. 1974); Lockhart Leasing Co. v. Commissioner, 54 T.C. 301, 303-304, 314 (1970), affd. sub nom. Lockhart Leasing Co. v. United States, 446 F.2d 269 (10th Cir. 1971).

Aderholt Specialty Company v. Commissioner, T. C. Memo 1985-491.

In support of the petitioners' position, the record includes a letter from [Redacted] signed by [Redacted] dated August 2, 2007 stating:

[Redacted]

Also in support of the petitioners' position is a letter to them from the president of

[Redacted] dated May 27, 2010, stating:

[Redacted],

[Redacted]

The petitioners have left unanswered many questions of significant interest. If the equipment was purchased by [Redacted] by June 2007, where is the signed purchase order or contract? If the equipment was purchased by June 2007, why was it necessary for [Redacted] to update the *quote* in August of 2007? If the equipment was purchased by June 2007, why did

[Redacted] sign a Customer Purchase Order to purchase the equipment on December 24, 2007? If the equipment was purchased by June 2007, why was the equipment not depreciated on [Redacted] 2007 income tax return? If the equipment was purchased by June 2007, why were the “rental” payments deducted as lease payments since, if the equipment had been purchased, recovery of the cost would have been required to have been recovered through depreciation<sup>3</sup>? If the equipment was purchased by June 2007, why was the investment tax credit claimed on the petitioners’ 2008 income tax return rather than on the 2007 return? If the equipment was purchased from [Redacted] on credit on or before June 22, 2007, why did [Redacted] (or some related entity) not file a [Redacted]? If the amounts asserted by [Redacted] was considered by [Redacted] to be payments of principal and interest on an installment sale, why was sales tax imposed?

These questions and the anticipated answers lead one to the conclusion that the petitioners purchased the assets in question either in December of 2007 or in January 2008. No document has been submitted on which the petitioners committed to purchase the [REDACTED] prior to December 2007. Any obligation that the petitioners became obligated for prior to December was apparently a verbal obligation which would have directly contradicted the written documents.

In summary, the bulk of the contemporary documents point to rental of the equipment until the purchase in December. However, the letter signed by [Redacted] indicating a sale was contemporary. So, of the contemporary documents, we have one letter indicating a sale. Documents indicating that the property was rented until December include the quote dated August 2, 2007, the Equipment Rental Agreement dated June 22, 2007, six invoices for rent due to [Redacted] Rentals, and the [Redacted] Invoice dated December 28, 2007. In addition, the tax returns of the petitioners treated the matter in a manner consistent with renting the property until

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<sup>3</sup> See Federal Tax Coordinator 2d, L-6209 (RIA 2010), Irby v. Commissioner, 30 T.C. 1166, 1174 (1958), affd. 274 F.2d 208 (5th Cir.1960).

purchased in January 2008. The rental invoices from [Redacted] asserting sales tax on the rental amounts also points to rental of the equipment until purchased in December. The vast majority of the information in the file is consistent with the auditor's position.

It is a long established tenet of tax law that tax credits and deduction are matters of legislative grace, and the burden is on taxpayers to demonstrate clearly that they are entitled to the credit claimed on their returns. Schumacher v. United States, 931 F.2d 650, 652 (10<sup>th</sup> Cir.1991). See INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84, 112 S. Ct. 1039, 1042-43, 117 L.Ed.2d 226 (1992).

The burden of proof is on the petitioners to show that they purchased the machinery at the time of their original use or before their original use of the machinery, thereby showing that they were entitled to the credit in question. The Commission finds that the petitioners have fallen far short of carrying their burden in this matter.

Wherefore, the Notices of Deficiency Determination dated January 20, 2010, are hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax and interest (computed to December 31, 2010):

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2006	\$1,375 \$302 \$1,677		
2008	4,134	354	<u>4,488</u>
		TOTAL DUE	<u>\$6,165</u>

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.

Receipt No. \_\_\_\_\_