BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 22894
[Redacted],	)	
	)	
Petitioners.	)	DECISION
	)	

[Redacted] (taxpayers) protested the Notice of Deficiency Determination dated January 26, 2010, asserting income tax, penalty, and interest in the total amount of $400,297 for taxable year 2005. The taxpayers disagreed with the computation of the gain on the sale of Idaho property they sold in 2005. The Tax Commission, having reviewed the file, hereby issues its decision.

BACKGROUND

The Income Tax Audit Bureau (Bureau) received information that showed the taxpayers sold real property located in Idaho in 2005. The Bureau researched the Tax Commission's records and found the taxpayers did not file an Idaho individual income tax return for that year. Idaho Code section 63-3026A(3)(ii) states that income shall be considered derived from or relating to sources within Idaho when such income is attributable to or resulting from the ownership or disposition of any interest in real or tangible personal property located in Idaho.

The Bureau sent the taxpayers letters asking them about the sale of the Idaho property and their requirement to file an Idaho income tax return. The taxpayers did not respond. The Bureau determined the taxpayers were required to file an Idaho income tax return, so the Bureau prepared a return for the taxpayers and sent them a Notice of Deficiency Determination.

The taxpayers protested the Bureau’s determination. They provided a copy of their 2005 federal income tax return and a breakdown of their basis in the Idaho property. The taxpayers

stated their federal return did not include the selling costs of the property. The taxpayers asked the Bureau to make the necessary changes to their [Redacted] return and the Idaho computation. The Bureau reviewed the information and adjusted its determination to agree with the federal income tax return the taxpayers provided. The Bureau sent the taxpayers a modified determination and a letter stating the taxpayers would need to amend their [Redacted] income tax return if they wanted any further basis adjustments. The taxpayers did not respond to the Bureau's letter, so the Bureau referred the matter for administrative review.

The Tax Commission sent the taxpayers a letter that discussed the methods available for redetermining a protested Notice of Deficiency Determination. The taxpayers contacted the Tax Commission and requested a telephone hearing. Prior to the hearing, the taxpayers provided documentation to support the selling costs of the property and documentation to support their basis in the tangible personal property that was included with the house sold, the Idaho property. During the hearing, two issues dominated the discussion; the basis of the personal property and the capitalizing of interest.

The Tax Commission, having considered the arguments presented, hereby modifies the Bureau's determination.

FINDINGS

In 2005, the taxpayers sold property in Idaho with a sales price of $3,450,000. This information was provided via a 1099S informational return and was confirmed by the taxpayers' settlement statement. The taxpayers provided a copy of their 2005 [Redacted] income tax return, whereupon they reported a basis in the property of $2,908,243. The taxpayers claimed that this basis did not include selling costs or their basis in the tangible personal property that was included with the house. The taxpayers provided a schedule of their basis in the property that

included the acquisition of the property, improvements, furnishings, interest, and selling costs. The resulting gain for the taxpayers on the sale of the property was $149,991.

The taxpayers included $150,000 of interest in their basis computation. Generally, interest is not an expense that is chargeable to a capital asset. The taxpayers argued that Internal Revenue Code (IRC) section 263A provides for mandatory capitalizing of preproduction expenses. They further argued that if IRC section 263A is not applicable, IRC section 266 allows them to elect to capitalize interest. The taxpayers also stated that since they received no Idaho tax benefit from the interest paid on the Idaho property, they should be able to capitalize the interest and add it to their basis. The taxpayers later contended that all the interest they paid on the property over the life of their ownership should be included in their basis. This would add approximately $1 million to the taxpayers' basis and eliminate any gain on the sale.

IRC section 263A states that certain expenses in the acquisition and production of certain property be capitalized. IRC section 263A(c) specifically excludes other certain property that includes personal use property. Personal use property is described as any property produced by the taxpayer that is not used by the taxpayer in a trade or business or an activity conducted for profit. In addition, Treasury Regulation section 1.263A-2 also states that IRC section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers. The Idaho property was not used in the taxpayers' trade or business or held for sale to their customers. From all appearances, the Idaho property was a vacation home or second home remodeled and furnished to the specific wants and desires of the taxpayers for their enjoyment. There is nothing in the record to indicate the property was used in a trade or business, or used in an activity conducted for profit. The taxpayers stated the property was purchased as an investment; however, their personal use of the property and its lack of being

used in an activity conducted for profit take it out of the mandatory capitalization rules of IRC section 263A.

IRC section 266 and its regulations provide for an election to charge interest to capital of certain designated property. The election is made on the original return of the year in which the item is chargeable to capital and, for the matter at hand, the election is only effective until the development or construction work is completed. Treasury Regulation section 1.266-1(c). Therefore, only interest paid during the construction phase of the project can be capitalized, and it had to be elected as such on the income tax return for the year of the construction. *See* Megibow, Isaiah, 21 TC 197 affd. (1955, CA3) 46 AFTR 1553, 218 F2d 687, 55-1 USTC 9133. However, the property at issue is specifically excluded from the definition of designated property (Treasury Regulation section 1.266-1(a)(2)). Treasury Regulation section 1.263A-8(b)(3)(ii) states property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit is excluded from the definition of designated property. As previously stated, the Idaho property was used for the personal enjoyment of the taxpayers; therefore, it was not designated property and interest cannot be capitalized.

Included in the sale of the Idaho property were furnishings the taxpayers purchased for use in the house, tangible personal property. The taxpayers stated the majority of the furnishings went with the house. Only a few items were personal to the taxpayers, and they were negotiated out of the sale. The taxpayers provided documentation to substantiate their basis in the furnishings that were included with the house.

The real property and the tangible personal property were sold in a single transaction for a lump sum. The sale information provided did not specify a separate sales price for the real property or the tangible personal property. The taxpayers did not provide an allocation of the

sale price; they were more concerned with getting their cost as their basis in the tangible personal property. Therefore, the Tax Commission made an allocation of the sales price based upon the ratio of the taxpayers' basis in the real property to their basis in the tangible personal property. The allocation of the sale price determines how much of the gain is capital gain and how much is ordinary gain.

Based upon the basis allocation, the taxpayers realized a gain on the sale of both the real property and the tangible personal property. The taxpayers' gain was in excess of the filing requirements of Idaho Code section 63-3030 for nonresidents; therefore, the taxpayers were required to file a 2005 Idaho income tax return.

Idaho Code section 63-3022H provides for a deduction of 60 percent of the capital gain of certain qualified property. The real property the taxpayers sold in 2005 met the requirements of qualifying property for the Idaho capital gains deduction. However, Idaho Code section 63-3022H also limits the Idaho capital gains deduction to the amount of capital gain net income from all property included in taxable income. After revising the gain on the sale to include the taxpayers' basis in their personal property, the taxpayers' did not have capital gain net income in their taxable income. The taxpayers' gains were offset by losses resulting in a net capital loss for the year. Therefore, no Idaho capital gains deduction is allowable on the taxpayers' 2005 Idaho income tax return. The result is that the taxpayers were required to report to Idaho a gain on the sale in the amount of $302,309.

The Bureau added interest and penalty to the taxpayers' Idaho tax liability. The Tax Commission reviewed those additions and found them appropriate to the taxpayers' revised tax liability. See Idaho Code sections 63-3045 and 63-3046.

WHEREFORE, the Notice of Deficiency Determination dated January 26, 2010, is hereby MODIFIED, in accordance with the provisions of this decision and, AS SO MODIFIED, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following tax, penalty, and interest:

YEAR	TAX	PENALTY	INTEREST	TOTAL
2005	$7,486	$1,872	$2,262	$11,620

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

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

DATED this _____ day of _____ 2011.

IDAHO STATE TAX COMMISSION

_____

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2011, 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.

_____