BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 23356
[Redacted],	)	
	)	
Petitioners.	)	AMENDED DECISION
	)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated August 24, 2010, asserting additional liabilities for Idaho income tax and interest in the total amount of $12,098 for 2007.

The sole issue is whether gain from the disposition (directly or indirectly) of the petitioners' interest in a limited liability company (filing tax returns as a partnership) qualifies for the Idaho capital gains deduction. In 1994, Mr.[Redacted] and two other individuals formed [Redacted], an Idaho limited liability company. All owners contributed cash to the LLC which, in turn, purchased three (apparently adjacent) parcels of commercial real property. In 2001, one of the owners left, leaving Mr. [Redacted] as a 50 percent owner of the LLC. In 2007, Mr. [Redacted] wished to withdraw from the LLC. He and the other member arranged for the LLC to distribute to Mr. [Redacted] an undivided one-half interest in the real property owned by the LLC in exchange for his interest in the LLC. On the same date, Mr. [Redacted] signed a contract to sell the interest in this real property to the other member who, in turn, conveyed the undivided one-half interest in the property back to the LLC.

Idaho Code § 63-3022H sets forth the authority for the deduction sought. It states, in part:

> Deduction of capital gains. (1) If an individual taxpayer reports capital gain net income in determining taxable income, eighty percent (80%) in taxable year 2001 and sixty percent (60%) in taxable years thereafter of the capital gain net income

from the sale or exchange of qualified property shall be a deduction in determining Idaho taxable income.

(2) The deduction provided in this section is limited to the amount of the capital gain net income from all property included in taxable income. Gains treated as ordinary income by the Internal Revenue Code do not qualify for the deduction allowed in this section. The deduction otherwise allowable under this section shall be reduced by the amount of any federal capital gains deduction relating to such property, but not below zero.

(3) As used in this section "qualified property" means the following property having an Idaho situs at the time of sale:

(a) Real property held at least twelve (12) months;

* * *

(f) In determining the period for which property subject to this section has been held by a taxpayer, the provisions of section 1223 of the Internal Revenue Code shall apply, <u>except that the holding period shall not include the holding period of property given up in an exchange, when such property would not have constituted qualified property under this section</u> without regard to meeting the holding period. (Underlining added.)

There are two arguments for the proposition that the gain doesn't qualify for the Idaho capital gains deduction. The first argument is that the step transaction doctrine applies, essentially holding that the petitioners sold an interest in an LLC which is an intangible. Intangibles don't qualify for the deduction in question. The second argument is that the holding period set out in Idaho Code § 63-3022H(3)(a) was not met.

Internal Revenue Code (IRC) § 1223 stated, in pertinent part:

Holding period of property. For purposes of this subtitle—

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included <u>the period for which he held the property exchanged</u> if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, <u>the same basis in whole or in part in his hands as the property exchanged</u>, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231 . For purposes of this paragraph—

(A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and

(B) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included <u>the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.</u> (Emphasis added.)

IRC § 732 states, in part:

Basis of distributed property other than money.

(a) Distributions other than in liquidation of a partner's interest.

(1) General rule.

The basis of property (other than money) distributed by a partnership to a partner <u>other than in liquidation</u> of the partner's interest shall, except as provided in paragraph (2) , be its adjusted basis to the partnership immediately before such distribution.

(2) Limitation.

The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(b) Distributions in liquidation.

<u>The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership</u> reduced by any money distributed in the same transaction.

(c) Allocation of basis.

(1) In general.

The basis of distributed properties to which subsection (a)(2) or (b) is applicable shall be allocated—

(A)

(i) first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)) in an amount equal to the adjusted basis of each such property to the partnership, and . . .

(Emphasis added.)

Internal Revenue Code § 735(b) states:

Holding period for distributed property.

In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a)(2)), there shall be included the holding period of the partnership, <u>as determined under section 1223</u>, with respect to such property. (Underlining added.)

The petitioners contend that Mr. [Redacted] basis in the property distributed to him was determined directly or indirectly (see IRC § 1223(1)) by the basis of the (real) property in the hands of the LLC. The argument is based upon the verbiage in IRC § 732(c)(1)(B)(i) which provides how the basis determined either in IRC § 732(a)(2) or (b) should be *allocated* when multiple assets are distributed. Even if such an allocation were necessary, the basis is determined solely by the petitioners' basis in the interest in the LLC. Only the allocation of such basis would be affected by the basis of the assets in the hands of the LLC.

Counsel for the petitioners also cites as authority [Redacted]. In addressing the issue, Mr. [Redacted] states the following:

> [Redacted]

In addressing the allocation of basis argument, the U.S. Tax Court addressed the matter as follows:

> Petitioner argues that its basis in its partnership interest following liquidation was equal to Tri-Eagle's basis in its assets. Petitioner incorrectly determined its basis following liquidation in the assets distributed by Tri-Eagle. Petitioner determined its basis under the incorrect assumption that prior to liquidation it owned a 100-percent interest in 50 percent of the partnership's asset. As a 50-percent partner of Tri-Eagle, however, petitioner did not own half of the partnership assets outright. Rather, it owned a 50-percent interest in each of the partnership's assets. Cal. Corp. Code section 15025 (West 1977 & 1987 Supp.). When petitioner purchased Louisiana-Pacific's 50-percent interest in Tri-Eagle for $7,500,000.00, the partnership terminated and petitioner acquired each partnership asset in a liquidating distribution. Although petitioner's basis in its original 50-percent interest in the partnership was not affected by its purchase of Louisiana-Pacific's interest, petitioner's partnership interest acquired from Louisiana-Pacific had a basis of $7,500,000.00 which exceeded Louisiana-Pacific's basis by $6,064,441.00. When Tri-Eagle liquidated, petitioner's basis in the distributed partnership assets should have been determined with reference both to petitioner's basis in its original partnership interest and its basis in the partnership interest acquired from Louisiana-Pacific. [footnote omitted] Petitioner's basis in the section 38 property it received in a liquidating distribution from Tri-Eagle, therefore, should have been determined solely by reference to its basis in its partnership interest in Tri-Eagle, as section 732(b) mandates. Petitioner's basis in the distributed property was not determined either in whole or in part by reference to Tri-Eagle's basis in the property prior to liquidation.

> Section 732(c) provides that a partner's basis in its liquidated partnership interest must be allocated among all of the partnership properties received in proportion to the partnership's basis in the properties. An argument is, therefore, possible that a partner's basis in its liquidated partnership interest is determined in part (i.e., indirectly) by reference to the partnership's basis in its assets. [footnote omitted] We cannot accept this argument in applying section 1.47- 3(f)(1)(ii)(d), Income Tax Regs., however, because section 732(c) provides a method for ALLOCATING the partner's basis among distributed partnership properties after the amount of that basis has been determined. (Emphasis in original.)

Siller Brothers, Inc., v. Commissioner, 89 T. C. 256, 262-264 (1987).

Sec. 1.732-1(b), Income Tax Regs. states the following:

> Distribution in liquidation. Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:
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> Example. Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

In this case, no cash was distributed. Therefore, Mr. [Redacted] basis in the real property was the same as his basis in his interest in the LLC. The Commission finds that Mr. [Redacted] basis was not determined either in whole or in part from the LLC’s basis in the real property.

Since the Commission finds that Mr. [Redacted] basis in the real property was his basis in his interest in the LLC, the Commission further finds that the federal holding period is determined pursuant to IRC § 1223(1). This provision of the law states that should the basis in the property received be determined in whole or in part by the taxpayer’s basis in the property given up (the interest in the LLC), then the *federal* holding period would include the taxpayer’s holding period for the interest in the LLC. However, since the interest in the LLC (an intangible) is not qualifying property, Idaho Code § 63-3022H(f) provides that the *Idaho* holding period of the property given up will not be included for the purposes of determining the taxpayer's holding period for purposes of Idaho Code § 63-3022H(3)(a). Therefore, Mr. [Redacted] holding period for the purposes of Idaho Code § 63-3022H is something less than a day.

It should also be noted that the Idaho holding period of property received in exchange for a partnership interest has been addressed in Idaho Income Tax Administrative Rule 171.03.a., which states in pertinent part:

> 03. Holding Periods of S Corporation and Partnership Property. (7-1-98)
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> a. Property Distributed by an S Corporation to a Shareholder or by a Partnership to a Partner. The holding period of property received in a distribution from an S corporation or partnership generally includes the holding period of the S corporation or partnership. However, the holding period of property received in exchange for a shareholder's stock or a partner's partnership interest does not include the holding period of the stock or partnership interest given up since the stock and partnership interests are nonqualifying property. (5-8-09)

This rule specifically excludes the time Mr. [Redacted] held his interest in the LLC from the holding period of the property received in exchange. Thus, for purposes of the Idaho capital gains deduction, Mr. [Redacted] holding period for the undivided interest in real property does not include the time he was a member of the LLC.

The Commission finds that Mr. [Redacted] did not meet the necessary holding period for the holding of the real property and, accordingly, is not entitled to the deduction sought.

The auditor asserted that the substance of the transaction should be given effect rather than the form chosen by the petitioners. At the beginning of the day of the transactions, Mr. [Redacted] owned an interest in a limited liability company. At the end of the day, Mr. [Redacted] had cash in place of the interest in the limited liability company. At the end of the day, the LLC had exactly the interest in the real property that it held at the beginning of the day.

At the end of the day, Mr. [Redacted] partner had exactly the same interest in the LLC that he would have had if he had purchased Mr. [Redacted] interest directly. The auditor cited the step transaction doctrine as the mechanism for the recharacterization of the transaction as a direct sale of Mr. [Redacted] interest in the LLC.

The petitioners insist that the form of the transactions should be respected. In support of their position, they cite Revenue Ruling 84-111 (dealing with different manners of tax free transfers of assets from a partnership to a corporation pursuant to Internal Revenue Code § 351.) The point that the petitioners wished to make in citing this Revenue Ruling was that in these examples, the forms of the transactions were respected. The Revenue Ruling 84-111 also stated, in part:

> In each situation, the steps taken by X, Y, and Z, and the partners of X, Y, and Z, were parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not devices to avoid or evade recognition of gain.

It is well established that the "incidence of taxation depends upon the substance of a transaction" rather than its mere form. Commissioner v. Court Holding Co., 324 U.S. 331, 334, 65 S.Ct. 707 (1945). In determining the substance of a transaction for federal tax purposes, we are guided by the foundational principles that the U.S. Supreme Court stated in Gregory v. Helvering, 293 U.S. 465, 469, 55 S.Ct. 266 (1935): "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." See also Knetsch v. United States, 364 U.S. 361, 365, 81 S.Ct. 132 (1960); Commissioner v. Court Holding Co., *supra* at 334.

Under Gregory v. Helvering, *supra*, "it is immaterial whether we are talking about 'substantial economic reality,' 'substance over form,' 'sham' transactions, or the like; rather the question is whether, under the statute and regulations here involved, the transaction affects a beneficial interest other than the reduction of taxes." United States v. Ingredient Tech. Corp., 698 F.2d 88, 94 (2d Cir.1983).

The Fifth Circuit Court of Appeals addressed a case with facts much like the ones before us. In that case, a partner withdrew from a partnership receiving an interest in partnership real estate which was then exchanged for other property. The other party to the exchange, in turn, conveyed the interest in the real property back to the partnership thereby becoming a partner in the partnership. In addressing the matter, the Court stated, in part:

> The Government argues that the ultimate consequence of these steps was in every material respect equivalent to that which would have resulted from a taxable sale. The partnership continued to own the same interest in the Pine Forest Apartments that it had purported to distribute in liquidation of Taxpayer's partnership interest, while the Blairs acquired Taxpayer's partnership interest in return for a $200,000 cash outlay. On the other hand, Taxpayer contends that the entire transaction was nothing more than a perfectly legitimate tax-free liquidation followed by an equally legitimate tax-free exchange of like-kind property under § 1031, and that it must therefore be governed by the long-established rule that a taxpayer may properly take advantage of any method allowed by law to avoid taxes. Rupe Investment Corp. v. Commissioner of Internal Revenue, 5 Cir., 1959, 266 F.2d 624, 629.
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> Transparent devices totally devoid of any non-tax significance to the parties [footnote omitted] cannot pass muster even though a literal reading of the statutory language might suggest otherwise. Commissioner of Internal Revenue v. P. G. Lake Inc., 1958, 356 U.S. 260, 266-267, 78 S.Ct. 691, 695-696, 2 L.Ed.2d 743, 749. The tax policy of the United States is concerned with realities rather than appearances, and when an illusory facade is constructed solely for the purpose of avoiding a tax burden the astute taxpayer cannot thereafter claim that a court is bound to treat it as being a genuine business arrangement. See Casner v. Commissioner of Internal Revenue, 5 Cir., 1971, 450 F.2d 379, pp. 395-396.

Crenshaw v. United States, 450 F.2d 472, 475 (1971), cert. denied, 408 U.S. 923 (1972).

The Tenth Circuit Court of Appeals addressed such a transaction as follows:

> We emphasize that under the end result test, our focus is not on the legitimacy of the intended result, but instead on whether the taxpayer undertook multiple steps to achieve a particular result. Thus, if a taxpayer engages in a series of steps that achieve a particular result, he cannot request independent tax recognition of the individual steps unless he shows that at the time he engaged in the individual step, its result was the intended end result in and of itself. If this is not what the taxpayer intended, then we collapse the series of steps and only give tax consideration to the intended end result. See Crenshaw v. United States, 450 F.2d 472, 475 (5th Cir.1971), cert. denied, 408 U.S. 923, 92 S.Ct. 2490, 33 L.Ed.2d 333 (1972).

True v. United States, 190 F.3d 1165, 1175 n.9 (1999).

The Circuit Court for the Federal Circuit more recently addressed the matter as follows:

> Though "there is no universal test applicable to step transaction situations," King, 418 F.2d at 516, courts generally have enunciated three basic tests that define the criteria upon which application of the step transaction doctrine applies-the "interdependence test," the "end result test," and the "binding commitment test." The interdependence test "requires an inquiry as to whether ... the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Id. (quotation marks omitted). The end result test examines whether it appears that separate transactions were "really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." Id. (quotation marks omitted). The binding commitment test examines whether there was a "binding commitment to undertake the later step" in a series of transactions. [footnote omitted] Penrod v. Comm'r, 88 T.C. 1415, 1429, 1987 WL 49335 (1987).
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> In King, we further noted that various expressions of the step transaction doctrine may have different meanings in different contexts, and that there "may be not one rule, but several, depending on the substantive provision of the Code to which they are being applied." King, 418 F.2d at 516 (quotation marks omitted).
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> Various opinions from the United States Tax Court have seemingly overlaid additional layers of analysis onto the three tests, stating that the doctrine eviscerates meaningless steps in a transaction, Esmark, Inc. v. Comm'r, 90 T.C. 171, 195, 1988 WL 5887 (1988) ("combines a series of individually meaningless steps into a single transaction"), and does not apply "when the result of the steps is what is intended by the parties and fits within the particular statute, and when each of the several steps and the timing thereof has economic substance and is motivated by valid business purposes," Tandy Corp. v. Comm'r, 92 T.C. 1165, 1173, 1989 WL 56149 (1989) (emphasis added). See also Portland Mfg. Co. v.

Comm'r, 56 T.C. 58, 77, 1971 WL 2503 (1971) ("The artificiality of the transaction is apparent when ... assets moved through the corporate hands ... in a matter of days, never pausing long enough to serve any business purpose, until they reached their ultimate destination ....").

The Falconwood Corp. v. United States, 422 F.3d 1339, 1350-51 (Fed Cir. 2005).

In this case, it appears that the assets reached their ultimate destination the same day. The question before us concerns the allowance of a deduction. Our original decision for this docket stated that if there is any ambiguity in the law concerning tax deductions, the law is to be construed strongly against the taxpayer. Hecla Mining Co. v. Idaho Tax Commission, 108 Idaho 147, 151, 697 P.2d 1161, 1165 (1985), Potlatch Corp. v. Idaho State Tax Commission, 128 Idaho 387, 913 P.2d 1157 (1996), Idaho State Tax Commission v. Stang, 135 Idaho 800, 802, 35 P.3d 113, 115 (2001). Counsel for the petitioners contends that the Commission is incorrect in citing these holdings by the Idaho Supreme Court and states that the statutes should be construed liberally in favor of the taxpayer. He cites United States v. Merriam, 263 U.S. 179 (1923), United States v. Maryland Casualty Co., 49 F.2d 556 (7th Cir. 1931), and Commissioner v. Bryson, 79 F.2d 397 (9th Cir. 1935) in support of his position. We note that none of the cases cited by counsel for the petitioners involve deductions.

The Commission continues to hold that deductions are a matter of legislative grace and that they should be strictly construed against the taxpayer. Commissioner v. Shoong, 177 F.2d 131, 132, (9th Cir. 1949), Deputy v. DuPont, 308 U. S. 488, 493 (1940), Helvering v. Northwest Steel Rolling Mills, 311 U.S. 46 , 49 (1940), Strange v. Commisioner, 270 F.3d 786, 787 (9th Cir. 2001). The Commission finds that the substance and end result of the transaction is a sale of a partnership interest, since no substantive reason other than tax avoidance is present.

WHEREFORE, the Notice of Deficiency Determination dated August 24, 2010, is hereby APPROVED, AFFIRMED, and MADE FINAL.

The petitioners have paid the deficiency in full. Therefore, no further demand is made.

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

DATED this ________ day of ___________________ 2011.

IDAHO STATE TAX COMMISSION

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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.

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