

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

In the Matter of the Protest of	)	
	)	DOCKET NO. 23555
[Redacted],	)	
	)	
Petitioners.	)	DECISION
_____	)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated September 8, 2010, asserting additional liabilities for Idaho income tax and interest in the total amounts of \$45,411 and \$726 for 2007 and 2008, respectively.

The petitioners reported gain from the sale of land and improvements on their 2007 Idaho income tax return in the amount of \$[Redacted] and claimed the Idaho capital gains deduction. During the audit, the auditor determined that it was not land and improvements which were sold, but instead, the petitioners sold an interest in an LLC. The taxable portion of this gain is the adjustment to income in this matter. The remaining adjustment in 2007 and the only adjustment in 2008 was a mechanical adjustment reflecting the amount of investment tax credit allowable.

The petitioners assert that the selling of the underlying assets is the same as the sale of the interest in the LLC. They stated that, "IRC section 741 states that the sale of a partnership interest is the same as if the underlying assets had been sold." The auditor contends that the asset sold was an interest in the LLC which is an intangible, therefore, not qualifying for the deduction provided by Idaho Code § 63-3022H.

The sales document is entitled “AGREEMENT FOR PURCHASE AND SALE OF MEMBERSHIP INTEREST.” One provision of the agreement stated:

1. Sale: Seller agrees to sell to Buyers and Buyers agree to purchase from Seller Seller’s membership interest in the LLC.

The agreement makes no mention of the sale of the underlying assets as opposed to the sale of the LLC membership. Therefore, the Commission finds that the item sold was the membership interest in the LLC and not the underlying property.

As stated above, the petitioners contend that Internal Revenue Code § 741 provides that the sale of a partnership interest is the same as the sale of the underlying assets. That code section states:

Recognition and character of gain or loss on sale or exchange. In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

We note that the section refers to the gain or loss as being considered to have been from the sale of or exchange of “a” capital asset as opposed to having been from an undivided interest in the many assets that may have been owned by the partnership.

A transaction such as the one here in question can provide dramatically different results depending upon the structure chosen by the buyer and seller. The price may be affected by the choice of this structure. Therefore, it is very important that all of the implications be considered in choosing a structure for such a transaction. Once chosen, however, the courts are very reluctant to allow a taxpayer to depart from this structure. The courts are not prone to speculate

as to how a transaction might have been differently structured to modify the tax results. The United States Supreme Court addressed the matter, in part, as follows:

This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, Higgins v. Smith, 308 U.S. 473, 477, 60 S.Ct. 355, 357, 84 L.Ed. 406 (1940); Old Mission Portland Cement Co. v. Helvering, 293 U.S. 289, 293, 55 S. Ct. 158, 160, 79 L.Ed. 367 (1934); Gregory v. Helvering, 293 U.S. 465, 469, 55 S. Ct. 266, 267, 79 L.Ed. 596 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. 'To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty.' Founders General Corp. v. Hoey, 300 U.S. 268, 275, 57 S.Ct. 457, 460, 81 L.Ed. 639 (1937); Television Industries, Inc. v. Commissioner of Internal Revenue, 284 F.2d 322, 325 (C.A.2 1960); Interlochen Co. v. Commissioner of Internal Revenue, 232 F.2d 873, 877 (C.A.4 1956). See Gray v. Powell, 314 U.S. 402, 414, 62 S. Ct. 326, 333, 86 L.Ed. 301 (1941).

Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U. S. 134, 149, 94 S.Ct. 2129, 2137, 40 L.Ed.2d 717, 727 (1974).

Accordingly, we need only decide whether the gain from the sale of the interest in the LLC qualifies for the Idaho capital gains deduction. If the membership may be characterized in whole or in part either as real property or as tangible personal property (following the nature of the assets held by the partnership), then gain from the disposition of the partnership interest may qualify for the deduction here in question. On the other hand, if a partnership interest is intangible personal property, regardless of the nature of the assets held by the partnership, then clearly the petitioners are not entitled to the capital gain deduction.

Idaho Code § 30-6-501 (from the Idaho Uniform Limited Liability Company Act) says of such interest:

Nature of transferable interest. – A transferable interest is personal property.

The nature of the membership is personal property regardless of the nature of the assets held by the LLC. Accordingly, the nature of the membership is not dependent on the nature of the assets held by the LLC and is not a direct interest in such assets.

Idaho Code § 63-3022H sets out the qualified property for the allowance of the Idaho capital gains deduction:

- (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;
  - (b) Tangible personal property used in Idaho for at least twelve (12) months by a revenue producing enterprise;
  - (c) Cattle or horses held for breeding, draft, dairy or sporting purposes for at least twenty four (24) months if more than one half (1/2) of the taxpayer’s gross income (as defined in section 61(a) of the Internal Revenue Code) for the taxable year is from farming or ranching operations in Idaho;
  - (d) Breeding livestock other than cattle or horses held at least twelve (12) months if more than one half (1/2) of the taxpayer’s gross income (as defined in section 61(a) of the Internal Revenue Code) for the taxable year is from farming or ranching operations in Idaho;
  - (e) Timber grown in Idaho and held at least twenty four (24) 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, 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 without regard to meeting the holding period.

No provision in Idaho Code § 63-3022H(3) provides for a capital gains deduction with regard to a gain from the disposition of an intangible asset. The LLC here in question filed as a partnership. Partnership interests have been deemed to be intangible assets. In re Vannoy, 176 B.R. 758, 771 (Bankr. M.D.N.C. 1994); In re Hartman, 102 B.R. 90 (Bankr. N.D. Tx 1989); In re Ellingsen MacLean Oil Co., Inc., 98 B.R. 284 (Bankr. W. D. Mich. 1989); Wharf v. Wharf, 306

Ill. 79, 137 N.E. 446 (1922). A membership in an LLC has also been deemed to be an intangible. Riverboat Development Inc. v. Indiana Department of State Revenue, 881 N. E. 2d 107 (2008).

The petitioners have not contended that the LLC membership interest is tangible property, and the Commission is not inclined to find that it is so. Accordingly, the Commission finds that the petitioners are not entitled to the deduction sought.

The auditor asserted a 10 percent penalty upon the additional tax imposed by the Notice of Deficiency Determination. The petitioners contend that the penalty should be abated. They state that, “[t]here was no intention to understate tax by leaving off income or overstating deductions.”

Idaho Code § 63-3046 set forth the authority for the imposition of the substantial understatement 10 percent penalty. It stated, in part:

- (d) (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent (10%) of the amount of any underpayment attributable to such understatement.
- (2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
  - (i) Ten percent (10%) of the tax required to be shown on the return for the taxable year, or
  - (ii) Five thousand dollars (\$5,000).

\* \* \*

- (5) The amount of the understatement under paragraph (4) shall be reduced by that portion of the understatement which is attributable to:
  - (i) The tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
  - (ii) Any item with respect to which the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a statement attached to the return.

While the petitioners argue that the law should be different, no authority was set forth supporting either that the interest in the LLC was other than an intangible asset or that the intangible asset should somehow qualify for the deduction sought. The Commission finds that there was not substantial authority for the petitioners' position. The AGREEMENT FOR PURCHASE AND SALE OF MEMBERSHIP INTEREST clearly states that an interest in a Limited Liability Company was sold. It was represented on the petitioners' Idaho income tax return that Land and improvements were sold. This a clear misrepresentation of the transaction. Therefore, the transaction was clearly not fully disclosed. Therefore, the Commission finds that the penalty was properly imposed.

WHEREFORE, the Notice of Deficiency Determination dated September 8, 2010, 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 May 15, 2011):

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$36,778	\$3,678	\$6,057	\$46,513
2008	673		67	740
				<u>\$47,253</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 \_\_\_\_\_ 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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