

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

In the Matter of the Protest of	)	
	)	DOCKET NO. 24059
[Redacted],	)	
	)	
Petitioners.	)	DECISION
_____	)	

[Redacted] (Petitioners) protested the Notice of Deficiency Determination dated March 29, 2011, asserting income tax, penalty, and interest for taxable years 2007 and 2008 in the total amount of \$4,232. Petitioners disagreed with the reclassification of the gain on the sales of real estate as ordinary income. Petitioners argued they were not in the business [Redacted] and the sales should be treated as the sales of capital assets. The Tax Commission, having reviewed the file, hereby issues its decision.

**BACKGROUND**

The Income Tax Audit Bureau (Bureau) selected Petitioners' 2007 and 2008 Idaho income tax returns to examine the Idaho capital gains deduction claimed each year. The Bureau obtained information from Petitioners and determined the property Petitioners sold should have been reported as sales to customers in the ordinary course of Petitioners' business and, therefore, any gain was ordinary income rather than capital gain income. The Bureau sent Petitioners a Notice of Deficiency Determination which Petitioners protested.

Petitioners stated the property [Redacted] was part of a larger five-acre tract they purchased [Redacted] for their residence. Petitioners built a house on a one-acre section of the land and used the remaining land [Redacted]. In 2006, Petitioners decided to take advantage of the real estate market and carved out [Redacted] lots from their remaining acreage. Petitioners stated the gain realized on the sale of the two houses built and sold was a gain on the sale

[Redacted] investment in the property. Petitioners stated they were not in the business of developing and selling real estate.

The Bureau referred the matter for administrative review. Petitioners requested a hearing which was held December 19, 2011. During the hearing, the following facts were presented. Petitioners owned the property [Redacted]. When Petitioners purchased [Redacted], it was outside [Redacted] city limits. [Redacted], the city annexed Petitioners' property which meant city services would soon be available and city improvements were on the way. The city's annexation brought in water, sewer, paved roads, and sidewalks over the next several years. As time progressed, Petitioners' neighborhood became less rural and more suburban. This resulted in an increase of property values throughout Petitioners' neighborhood.

After several years, and due to the economic climate of real estate, Petitioners decided to take advantage of the housing boom and subdivided the northeast corner of their acreage. Petitioners stated they divided their property, improved the lots, and built spec. homes to get the most out of their 34 year investment in the property. Petitioners contracted to have [Redacted] houses built at the same time. One of the houses sold [Redacted], another sold [Redacted], and the third was kept as rental property.

During the years 2006 to 2008, [Redacted] was not employed in his usual occupation [Redacted]; he was retired [Redacted]. [Redacted] occupation and training [Redacted]. In 2000, [Redacted] semi-retired and started his own business [Redacted]. Petitioners also acquired their first rental property in 2000. Petitioners acquired and sold other rental property and built their most recent rental on their [Redacted] property.

[Redacted]. In the 1980s, Petitioners were audited by the Tax Commission for their [Redacted] activities, and it was determined that Petitioners' [Redacted] activities did not rise to the level of a business resulting in the disallowance of Petitioners' [Redacted] deductions.

Petitioners stated they did not purchase [Redacted] with the intention of someday developing the property. They purchased it as an investment and for their personal use and enjoyment. Petitioners had no experience as a developer nor did they have any building experience. [Redacted] did obtain a [Redacted] license, but not until after Petitioners sold the house in 2008. [Redacted] never utilized his [Redacted] license because [Redacted], [Redacted] suffered a heart attack and did not work until [Redacted] 2009. When [Redacted] did go back to work, he went back to his former training and occupation.

Petitioners stated they believe their tax preparer incorrectly prepared their 2007 and 2008 returns. Their returns were prepared as if Petitioners were in the business [Redacted]; a schedule C was prepared [Redacted]. Petitioners stated they were not in the trade or business of building houses for sale. Petitioners oversaw and directed [Redacted] but had little to do with the actual building. Petitioners [Redacted] the houses to maximize their potential gain on the sale of their investment. Petitioners believed that by putting houses on the lots, the lots were more attractive and it increased the chances of them reaping greater gains.

### **LAW AND ANALYSIS**

The issue to be determined is whether the properties sold should be taxed as ordinary income or as capital gain. In its determination that the sales should be treated as ordinary income, the Bureau first ruled out the special rule of Internal Revenue Code (IRC) section 1237 which allows a taxpayer to treat the sales of subdivided lots as capital gains if three requirements are met. In this case, Petitioners failed the substantial improvements test for capital gains

treatment. Treasury Regulation section 1.1237-1(c)(4) specifically identifies residential building as a substantial improvement. Consequently, Petitioners do not get the special treatment of IRC section 1237.

However, IRC section 1237 is not exclusive in its application. *See* Treasury Regulation section 1.1237-1(a)(4)(i). Failure to qualify under IRC section 1237 does not necessarily mean Petitioners held the property primarily for sale in the ordinary course of their business. Gibson, Hope Jr., (1981) T.C. Memo 1981-240. If the sales can be shown to be the sales of capital assets, as provided in IRC section 1221(a), Petitioners' gain will be treated as a capital gain.

IRC section 1221 states in pertinent part:

Capital asset defined

(a) In general. For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; . . .

Therefore, the determining issue in this case is whether the lots and houses sold by Petitioners were sold to customers in the ordinary course of Petitioners' trade or business.

The disposition of property and its tax implications is one of the most uncertain areas in the field of litigation. Byram v. U.S., 83-1 USTC ¶ 9381, (CA5 1983). In determining the character of a piece of property, the original acquisition purpose plays an important role. IRC section 1221 uses the term "primarily" in its exclusion to the definition of capital assets for property held for sale to customers in the ordinary course of a trade or business. In Malat v. Riddell, 383 U.S. 569, 86 S.Ct. 1030, 16 L.Ed.2d 102 (1966), the Supreme Court held the meaning of "primarily" as used in IRC section 1221(1) as "of first importance" or "principally." Petitioners stated the primary purpose for

acquiring the property was for their personal use and as an investment. Petitioners stated the investment purpose has not changed.

A taxpayer's purpose in holding property may change and, therefore, the character of the property for tax purposes may be different at the time of sale than at the time acquired. Klarkowski v. Commissioner, T.C. Memo. 1965-328, (24 TCM 1827). There may also be externally induced factors or events forcing an alteration of plans causing a change in the character of property. While the purpose the property was held at the time of sale is determinative, earlier events may be looked at to determine precisely what the purpose was at the time of sale. Biedermann v. Commissioner, 68 T.C. 1 (1977), citing Maddux Construction Co. v. Commissioner, 54 T.C. 1278 (1970).

The "holding purpose" inquiry may appropriately be conducted by attempting to trace Petitioners' primary holding purpose over the entire course of their ownership of the property. See Malat v. Riddell, supra; Devine v. Commissioner, 558 F.2d 807 (5th Cir. 1977). In this case, it is clear Petitioners acquired the subject properties as part of a larger tract for their personal use and investment. But is there evidence of a change in Petitioners' primary holding purpose? Suburban Realty Co. v. United States, 615 F.2d 171 (1980).

Deciding this issue is also dependent on whether the property sold was property held primarily for sale to customers in the ordinary course of business. In Malat, the Supreme Court explained the purpose of IRC section 1221(1) as follows:

The purpose of the statutory provision . . . is to differentiate between the "profits and losses arising from the everyday operation of a business" on the one hand (*Corn Products Refining Co. v. Commissioner of Internal Revenue*, 350 U.S. 46, 52) and "the realization of appreciation in value accrued over a substantial period of time" on the other. (*Commissioner of Internal Revenue v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134.)

Therefore, for ordinary income treatment, Petitioners had to be in the trade or business [Redacted]. In determining whether gains realized from the sale of property are capital gains or

income derived from the sale of the property in the ordinary course of business, the Court in Suburban Realty Co. v. United States, supra, stated it is important that the proper questions be asked that are demanded by the statute. Those questions are:

- (1) was the taxpayer engaged in a trade or business, and, if so, what business?
- (2) was the taxpayer holding the property primarily for sale in that business? and
- (3) were the sales contemplated by the taxpayer “ordinary” in the course of that business?

The statutory language does not demand that property actually be sold while a taxpayer is still actively engaged in his trade or business for ordinary income treatment to be required. Rather, it demands that the property was held primarily for sale in that business. Suburban Realty Co. v. United States, supra.

Determining whether a taxpayer’s activities rise to a level which constitutes “carrying on a business” requires an examination of the facts in each case. Higgins v. Commissioner, 312 U.S. 212, 217 (1941). In this case, Petitioners purchased a [Redacted] parcel [Redacted] for the purpose of building a home and having additional land for their personal use and enjoyment. [Redacted]. Prior to their decision to sell part of their property, Petitioners made no improvements to the lots sold. Any and all improvements that benefited the lots were made by the city [Redacted] as a result of annexing the area where Petitioners lived.

In 2006, Petitioners decided to capitalize on the local housing boom and carved out [Redacted] lots from their [Redacted] parcel. On three of the lots, Petitioners built houses, and the fourth was apparently given [Redacted]. Petitioners’ [Redacted] houses were all built [Redacted]. Two of the houses were put on the market, while the third house, Petitioners kept as rental property. One house sold in 2007, and the second house sold in 2008.

At the time Petitioners’ houses were being built, [Redacted] was unemployed. Petitioners stated [Redacted] was semi-retired [Redacted]. Petitioners purchased their first rental property in

2000. Petitioners stated the closest [Redacted] got to the [Redacted] industry was him hiring out [Redacted]. [Redacted] did not have a [Redacted] license until after the two houses sold. [Redacted] obtained a [Redacted] license for his work [Redacted].

IRC section 1221 states that a capital asset is not property held for sale to customers in the ordinary course of the taxpayer's trade or business. Therefore, a determination of Petitioners' trade or business is necessary. Years prior to the sales of the property, [Redacted] was employed and semi-retired [Redacted]. [Redacted] was employed [Redacted] for 20 years, including the years of the sales. Petitioners had rental property [Redacted], but neither developed and sold residential building lots and houses. Petitioners did not acquire additional property to subdivide nor did they continue to subdivide, build houses, or sell their remaining acreage. In Boomhower v. United States, 74 F.Supp. 997 (N.D. Iowa 1947) the court stated:

It would seem that to carry on a business conveys the idea of progression, continuity and sustained and normally incident activity, and does not mean the performance of single disconnected acts. Continuity, in the case of a real estate enterprise, would hence seem to connote that characteristic of the business as a 'going concern,' as distinguished from sporadic activity lacking the studied purpose or continuing objective of the entrepreneur-realtor.

In discussing the regularity of a business, the court stated in U.S. v. Winthrop, 417 F. 2d 905 (5<sup>th</sup> Cir. 1969), "The concept of normalcy requires for its application a chronology and a history to determine if the sales of lots to customers were the usual or a departure from the norm. History and chronology here combine to demonstrate that (taxpayer) did not sell his lots as an abnormal or unexpected event." In this case, Petitioners had no history of developing or subdividing property and no history of building and selling houses; it was a departure from their norm of holding their property for their personal use and enjoyment. However, when a business starts up, there is no history or track record; although, with startup businesses, continuity or going concern is readily apparent. This is not the case with Petitioners; continuity and going

concern are absent.

Carrying on a business implies an occupational undertaking to which one habitually devotes time, attention, or effort with substantial regularity. Merely disposing of investment assets at intermittent intervals, without more, is not engaging in business, even though some preliminary effort is necessary to render the asset saleable. Fahs v. Crawford, 161 F.2d 315 (1947) citing Snell v. Commissioner, 5 Cir. 97 F.2d 891.

In Farley v. CIR, 7 T.C. 198 (1946), the court stated;

It is unquestionably true that the frequency and continuity with which a particular activity is carried on is a primary consideration in determining whether such activity constitutes a trade or business. It is significant to note, however, that the cases which have applied this test to real estate transactions involved elements of development and substantial sales activity which are essentially lacking in the instant case.

The extent of development activity and improvements is highly relevant to the question of whether a taxpayer [Redacted]. Development activity and improvements may also be relevant to a taxpayer's holding purpose, but, standing alone, some degree of development activity is not inconsistent with holding property for purposes other than sale. The extent of development activity also seems to be only peripherally relevant to the "ordinariness" question. Suburban Realty Co. v. United States, supra.

Petitioners, as well as most everyone in Idaho, knew Idaho was in the midst of a housing boom in the mid 2000s. Petitioners decided to cash in on the boom by selling off part of their acreage. Petitioners also decided they could increase their properties' values [Redacted]. In effect, what Petitioners were doing was to render more attractive a capital asset already owned in order to sell it. This is not enough to put Petitioners into the real estate business. Fahs v. Crawford, 161 F.2d 315 (1947). To hold that Petitioners, under the circumstances of this case, became engaged in the trade or business of selling real estate would be unnecessary distortion of

the facts and an avoidance of the purposes of the capital gain provisions of the statute. Farley v. CIR, 7 T.C. 198 (1946).

So, were Petitioners engaged in a sufficient quantum of focused activity to be considered engaged in a trade or business? Suburban Realty Co., supra. The Tax Commission found the absence of continuity and going concern key to the determination of Petitioners being in the trade or business of developing and selling real estate. Judge Gee's statement in his dissenting opinion to Biedenhard Realty Co. Inc. holds a lot of truth in these types of cases, "And while I entirely agree with the majority's redundant warning that 'once an investment does not mean always an investment,' id. at 423, I would also suggest that once a sale does not mean always a business."

Review of the information provided and available in the file has convinced the Tax Commission that Petitioners were not in the business [Redacted]. Therefore, the characterization of the gain realized on the sale of the properties should be properly classified as capital gain. Therefore, Petitioners' schedule C is reclassified as a gain on the sale of a capital asset with the appropriate substantiated expenses and basis adjustments allowed.

The Bureau added penalty and interest to Petitioners' Idaho tax liability. The Tax Commission reviewed those additions and found the interest addition appropriate and in accordance with Idaho Code section 63-3045. However, the Tax Commission does not agree the negligence penalty for disregard of the tax law and rules resulting in a substantial understatement of taxable income is appropriate to the modified deficiency.

THEREFORE, the Notice of Deficiency Determination dated March 29, 2011, and directed to [Redacted] is AFFIRMED AS MODIFIED by this decision.

IT IS ORDERED that Petitioners pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$373	\$82	\$455
2008	220	34	<u>254</u>
		TOTAL DUE	<u>\$709</u>

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

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2012.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2012, 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.  
  
\_\_\_\_\_