

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 24156
[Redacted],)	
)	
Petitioner.)	DECISION
_____)	

[Redacted] (petitioner) protests the Notice of Deficiency Determination dated May 24, 2010, and issued by the auditor for the Idaho State Tax Commission (Commission). The Notice of Deficiency Determination asserted additional liabilities for Idaho income tax and interest in the total amount of \$39,640 for 2008.

The petitioner was the owner of [Redacted] a wholly owned S corporation. [Redacted] owned a 25 percent interest of [Redacted]. On January 5, 2006, [Redacted] sold an interest in farmland on the installment basis. In 2008, the purchaser of the property determined that it would be unable to fulfill its obligations under the installment sale and [Redacted] agreed to receive a portion of the property back via a deed in lieu of foreclosure. This produced a gain from the repossession. The petitioner reported the gain and claimed the Idaho capital gains deduction with regard to this gain. The auditor denied this deduction stating that the gain didn't qualify since it was produced by a foreclosure and not by a "sale or exchange" as required by Idaho Code § 63-3022H which stated, in pertinent 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) Property held by an estate, trust, S corporation, partnership, limited liability company or an individual is "qualified property" under this section if the property had an Idaho situs at the time of sale and is:

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

Administrative Rule 010 stated, in part:

06. Sale. A sale is defined as a transaction in which title passes from the seller to the buyer, or when possession and the burdens and benefits of ownership are transferred to the buyer. A sale may have occurred even if the buyer does not have the right to possession until he partially or fully satisfies the terms of the contract. (3-20-97)

* * *

08. Terms. Terms not otherwise defined in the Idaho Income Tax Act or these rules shall have the same meaning as is assigned to them by the Internal Revenue Code including Section 7701 relating to definitions of terms. (3-20-97)

Administrative Rule 010 stated, in part:

03. Gain from Forfeited Rights and Payments. Gain attributable to a cancellation, lapse, expiration, or other termination of a contract right or obligation does not qualify for the Idaho capital gains deduction. This includes any gain from the lapse of an option or from forfeited earnest money, down payment, or similar payments, related to otherwise qualifying property. (4-7-11)

When property is sold on the installment basis, and the seller reports the sale on the installment basis pursuant to Internal Revenue Code (IRC) § 453, a gross profit percentage is computed by dividing the gain from the sale by the total sales price. As funds are received, the portion that is deemed to be profit is reported as gain and the remainder is considered to have been a recovery of the taxpayer's basis in the property. When the property is reacquired through a foreclosure, all or a portion of the funds having previously been considered to be a recovery of the taxpayer's basis in the property may be (and in this case was) reclassified as gain. The additional gain from the reclassification of the funds initially deemed to have been a recovery of basis is reportable in the year of the foreclosure rather than being reported in the year that the

funds were received. Therefore, typically, all of the funds deemed to be the gain from the reacquisition were received prior to the foreclosure. In addressing this, the U.S. Tax Court stated, in part:

To that end, section 1038(a) expressly disallows any recognition of gain or loss in connection with the reacquisition itself. Section 1038(b) requires only that the seller recognize and report as gain that amount of any cash or other property that was received by the seller on the original sale and whose recognition was deferred under section 453. Such recognition rectifies the imbalance created by the section 453 deferral, which Congress allowed in order to sidestep “the seemingly elementary issue of when the ‘amount realized’ by the seller includes the value of the buyer's obligations to make the future payments”. Bittker & McMahon, *Federal Income Taxation of Individuals*, sec. 29.12, at 29–34 (2d ed. 1995 & Supp.1997).

Hovhannissian v. Commissioner, T. C. Memo 1997-444.

Regulation 1.1038-1 addresses the nature of the gain from a reacquisition, in part, as follows:

(d) Character of gain resulting from a reacquisition. Paragraphs (b) and (c) of this section set forth the extent to which gain shall be derived from a reacquisition to which paragraph (a) of this section applies, but the rule provided by section 1038 and this section do not affect the character of the gain so derived. The character of the gain resulting from such a reacquisition is determined on the basis of whether the gain on the original sale was returned on the installment method or, if not, on the basis of whether title to the real property was transferred to the purchaser; and, if title was transferred to the purchaser in a deferred-payment sale, whether the reconveyance of the property to the seller was voluntary. For example, if the gain on the original sale of the reacquired property was returned on the installment method, the character of the gain on reacquisition by the seller shall be determined in accordance with the rules provided in paragraph (a) of §1.453-9. (Underlining added.)

Paragraph (a) of Regulation 1.453-9 stated:

In general. Subject to the exceptions contained in section 453(d)(4) and paragraph (c) of this section, the entire amount of gain or loss resulting from any disposition or satisfaction of installment obligations, computed in accordance with section 453(d), is recognized in the taxable year of such disposition or satisfaction and shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received by the taxpayer. (Underlining added.)

As stated by the U.S. Tax Court, the purpose of the recognition of the gain upon the repossession was to rectify the imbalance created by the IRC section 453 deferral. If the petitioners had reported the entire gain at the time of the sale rather than reporting pursuant to IRC § 453, the entire gain would have been reported and the Idaho capital gain deduction would have been allowed on the entire gain. If the auditor's position is sustained, rather than attempting to minimize the differences in reporting, the opposite would be true. The differences would be maximized by subjecting a portion of the gain to tax as ordinary income.

The fundamental principle of interpreting any statute is to determine the legislative intent or purpose in enacting the statute¹. The effect of the auditor's position would be to penalize those who were required to repossess property which they had sold. A taxpayer disposing of property at a net loss through a sale, a subsequent repossession, and a resale could be required to report income from the transactions pursuant to the auditor's position. The Commission doubts this was the intent of the legislature.

The Commission finds that the gain recognized pursuant to the reacquisition in this matter is from the sale or exchange of qualifying property as prescribed in Idaho Code § 63-3022H(3)(a) and, accordingly, the petitioners are entitled to the Idaho capital gains deduction with regard to such recognized gain.

¹ 32 *Philbrook v. Glodgett*, 421 U.S. 707, 713 (1975); *George v. United States District Court for the Central District of California*, 219 F.3d 930, 936 (9th Cir. 2000); *Schwenk v. Hartford*, 204 F.2d 1187, 1202 n.12 (9th Cir. 2000); *Pressley v. Capital Credit & Collection Service Inc.*, 760 F.2d 922, 923 (9th Cir. 1985)(per curiam); (*Calatayud v. State of California*, 959 P.2d 360, 365 (Cal. 1998) (“The fundamental purpose of statutory construction is to ascertain the intent of the lawmakers so as to effectuate the purpose of the law.”) (internal quotation and citation omitted); *Metropolitan Dade County v. Chase Federal Housing Corp.*, 737 So.2d 494, 500 (Fla. 1999); *Carr v. New York State Board of Elections*, 356 N.E. 2d 713, 715 (N.Y. 1976) (“In statutory interpretation, legislative intent is the great and controlling principle.”)(citation omitted); 73 AM. JUR. 2D *Statutes* § 145 (1974).

THEREFORE, the Notice of Deficiency Determination dated May 24, 2010, is hereby
CANCELLED.

An explanation of the taxpayer's 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]
Copy mailed to:

Receipt No.

[REDACTED]
[REDACTED]
