

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 24331
[Redacted],)	
)	
Petitioners.)	DECISION
_____)	

[Redacted] (Petitioners) protested a Notice of Deficiency Determination (NODD) issued by the Idaho State Tax Commission (Commission) on June 6, 2011. In taxable year 2007, Petitioners sold real property and claimed a capital gains deduction under Idaho Code § 63-3022H. The Commission’s Income Tax Audit Bureau (Audit) disallowed the capital gains deduction because Petitioners did not hold the property for the time required by statute.

Petitioners requested a telephonic informal hearing which was held on December 6, 2011. After hearing Petitioners’ arguments presented at the informal hearing and having reviewed the file, the Commission is prepared to issue its decision.

BACKGROUND

In 1996, Petitioners, along with others, formed [Redacted]. [Redacted] is a limited liability company organized under the laws of the state of [Redacted]. Petitioners owned a 50 percent beneficial interest in [Redacted] for the entire life of the LLC.

The owners of [Redacted] formed the LLC to develop a [Redacted], Idaho. The members planned, managed, and supervised the construction of the [Redacted] throughout the entire process. Upon completion, [Redacted] retained ownership of the [Redacted] and leased, maintained, and managed the property for over ten years.

In February 2007, [Redacted] negotiated the sale of the [Redacted] to an unrelated third party. To facilitate the sale and to permit each member the opportunity to engage in a section 1031 like-kind exchange, [Redacted] distributed the [Redacted] property to its members in accordance to each members LLC ownership interest on June 4, 2007. Petitioners received a 50 percent interest in the distributed property. On June 12, 2007, the members sold the [Redacted] property to the unrelated third party. Upon the sale, Petitioners recognized a \$[Redacted] capital gain. On their 2007 Idaho nonresident income tax return, Petitioners claimed a \$[Redacted] capital gains deduction pursuant to Idaho Code § 63-3022H. Audit denied this deduction on the grounds Petitioners' holding period for the property did not meet the requirement of Idaho Code § 63-3022H. Audit's analysis concluded that [Redacted] made a liquidating distribution to its members when it distributed the real property. Under Internal Revenue Code §1223(1), Petitioners' holding period for the distributed property would normally receive a tacked on holding period for time they held their interest in [Redacted]. Audit determined that the holding period could not be tacked on under Idaho Code § 63-3022H because the ownership interest held in the LLC was non-qualifying property.

LAW AND ANALYSIS

A. [Redacted] made a liquidating distribution when it distributed the real property to

Petitioners and the other LLC owners.

i. *Washington LLC Laws will not apply to Idaho Tax Law*

Petitioners contend that Washington law governs the internal affairs of the LLC and, by extension, the determination of whether a distribution by the partnership will be a liquidating distribution. Petitioners correctly interpret Idaho Code § 30-6-801 which reads in relevant part "The law of the state or other jurisdiction under which a foreign limited liability company is

formed governs: (a) The internal affairs of the company.” (Emphasis added) This statute provides that Washington LLC laws will govern the internal affairs of the LLC; this provision does not extend the authority of the other states’ statutes to determine, influence, or control an Idaho state tax liability. Petitioners provided a lengthy explanation regarding Washington laws on dissolution and dissociation only to conclude that the laws of Washington preclude the Commission from finding the LLC made a liquidating distribution. However, the Commission finds these arguments unconvincing. Whether an entity dissolves for state purposes is an inquiry separate and distinct from the determination of whether the LLC made a liquidating distribution to its partners for tax purposes. Thus, while Petitioners may be correct in their analysis that the Partnership did not dissolve under Washington law until months after the distribution of real property, such analysis is inapplicable to the Commission’s ultimate determination.

ii. *Under the IRC, [Redacted] made a liquidating distribution to its owners.*

The applicable provisions of the Internal Revenue Code (IRC) relating to the taxation of partnerships will apply to the case at hand. Idaho tax laws follow the IRC insofar as possible when calculating taxable income. To achieve this, Idaho applies certain “provisions ...relating to the definition of income, exceptions therefrom, deduction..., accounting methods, taxation of trusts, estates, partnerships and corporations, basis and other pertinent provisions to gross income as defined therein...”¹ Idaho then applies its own modifications and provisions to calculate Idaho taxable income.

[Redacted] elected to be taxed as a partnership; any reference to a partnership for the following analysis will apply equally to [Redacted]. Under the IRC partnership laws, there are two types of distributions: current distributions and liquidating distributions. IRC § 761.

¹ Idaho Code § 63-3002

Treasury Regulation 1.761-1 reads in pertinent part:

(d) Liquidation of partner's interest. ... A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share.

In other words, if the distribution is not a liquidating distribution, it will be a current distribution. Current distributions include partial liquidating distributions and other ordinary distributions of a partner's distributive share. A liquidating distribution is a distribution or series of distributions which eliminate the partner's entire interest in the partnership.² The timing of the distributions or series of distributions can span over time.³ In fact, a series of distributions spanning over a year may be considered a liquidating distribution for tax purposes.⁴ Additionally, a liquidating distribution can occur before a partnership is dissolved under state law. Treasury Regulation 1.704-1(b)(2)(ii)(g) reads as follows:

(g) Liquidation defined. For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of § 1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners).

From the language of this provision, it is possible for a partner to receive a liquidating distribution even though the partnership continues operations for the purpose of winding up its affairs. Additionally, it is entirely possible that the partnership may liquidate for tax purposes and still remain a valid legal entity under state law.

The facts presented by Petitioners support audit's position that Petitioners received a

² IRC § 761 (d).

³ Treas. Reg. 1.761-1(d).

⁴ Id.

liquidating distribution when [Redacted] distributed the real property to the LLC members. On June 4, 2007, [Redacted] distributed an undivided interest in the real property to Petitioners and the other owners. No other distributions were made. [Redacted] held no other assets. For tax purposes, this is a liquidation of the partnership and the partner's interest in the partnership. Thus, the Commission finds audit appropriately determined [Redacted] made a liquidating distribution to Petitioners when it distributed the real property.

B. Petitioners' holding period is determined under IRC § 1223(1); the exception in Idaho Code § 63-3022H(3)(f) applies.

Idaho Code § 63-3022H(1) grants taxpayers a deduction for capital gains meeting certain eligibility requirements. It states in part:

(1) If an individual taxpayer reports capital gain net 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 of exchange of qualified property shall be a deduction in determining Idaho taxable income.

“Qualified property” for purposes of Idaho Code § 63-3022H includes real property held at least twelve (12) months, tangible personal property used in Idaho for at least twelve (12) months by a revenue-producing enterprise, cattle or horses held for specific purposes, breeding livestock, and timber.⁵ An interest in an LLC is not qualified property for purposes of Idaho Code § 63-3022H.

Idaho Code § 63-3022H(3)(f) states that when determining the holding period of the property at issue, “the provisions of section 1223 of the Internal Revenue Code shall apply.” However, regardless of the holding period provisions of IRC § 1223, there is a general exception that “the holding period shall not include the holding period of property given up in an exchange,

⁵ I.C. § 63-3022H(3).

when such property would not have constituted qualified property under this section...”⁶

i. *IRC § 1223 Holding Period*

Internal Revenue Code § 1223 prescribes two methods of determining the taxpayer’s holding period of property received in a transaction. If a taxpayer’s basis in property received is the same as the basis of the property given up in the exchange, then IRC § 1223(1) says that the holding period of the property received will include the period the taxpayer held the property he gave up in the exchange. On the other hand, if a taxpayer’s basis in the property received is transferred or the same as the basis of the person from whom the taxpayer received the property, then IRC § 1223(2) says that the holding period of the property received will include or “tack on” the holding period of the person from whom the taxpayer received the property.

IRC § 732(b) provides that a partner’s basis in distributed property received in a liquidating distribution is equal to the adjusted basis in his partnership interest. Thus, for liquidating distributions, the basis of the property received from the partnership is determined by the receiving partner’s basis in his partnership interest. Because the basis of the property received is determined by the partnership interest given up in the exchange, IRC § 1223(1) will apply and the holding period of the property received from the liquidating distribution will take the same holding period as the partner’s holding period for his partnership interest.

As discussed above, Petitioners received a liquidating distribution when [Redacted] distributed the real property. Thus, Petitioners’ basis in the real property is determined according to the adjusted basis of Petitioners’ interest held in [Redacted]. Because Petitioners’ basis in the property received is determined according to their basis in their LLC interest, IRC § 1223(1) will apply, not IRC § 1223(2). Petitioners’ holding period for the property received from [Redacted] equals the holding period of their interest in [Redacted], or roughly 11 years.

⁶ I.C. § 63-3022H(3)(f).

- ii. *Idaho Code § 63-3022H will not permit Petitioners to include the holding period of their LLC interest in the holding period of the distributed property.*

For purposes of Idaho’s capital gains deduction, the exception in Idaho Code § 63-3022H(3)(f) applies. Idaho Code § 63-3022H(3)(f) states that IRC § 1223 is used to determine the holding period “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.” Petitioners may not include the holding period of the LLC ownership interest to the holding period of the distributed real property in order to qualify for the capital gains deduction because an ownership interest in an LLC is not “qualified property.” When Petitioners sold the property on June 12, 2007, their holding period in the real property was less than a week. Petitioners did not meet the necessary holding period as determined by Idaho Code § 63-3022H(3)(f) in order to qualify for the capital gains deduction.

CONCLUSION

The Commission finds Audit appropriately denied Petitioners’ capital gains deduction. Under Idaho Code § 63-3022H, Petitioners held the real property for less than a week. For these reasons, the Commission affirms the NODD in its entirety.

THEREFORE, the NODD dated June 6, 2011, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED Petitioners pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$143,119	\$21,468	\$30,497	\$195,084

Interest for the above deficiency is calculated through July 30, 2012.

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.
