BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 24716
[Redacted],	)	
	)	
Petitioners.	)	DECISION
	)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination (NODD) issued by the auditor for the Idaho State Tax Commission (Commission) dated November 17, 2011. The NODD included an adjustment to disallow a capital gains deduction and allow an adjustment to itemized deductions; the result was a refund due the Petitioners of $360 plus interest in the total amount of $371 for taxable year 2010.

The petitioners are partners in [Redacted]. In taxable year 2010, the petitioners and the other partners in [Redacted] claimed the Idaho capital gains deduction showing on Form CG the sale of commercial building. The auditor disallowed the capital gains deduction. Whether this deduction should be allowed is the sole issue to be decided for this docket.

In 2010 [Redacted] admitted a new partner. To accomplish this, [Redacted] distributed to each existing partner an undivided interest in partnership real property in exchange for a specified portion of their membership interests. The partners then “sold” a portion of their undivided interests to the new partner. According to the recitals in the Purchase and Sale Agreement, the new partner was required to transfer the property he “purchased” back to [Redacted] in exchange for his partnership interest and the partners were obligated to approve the exchange. All prior partners continued as partners in [Redacted] with reduced membership interest.

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;

* * *

The argument for the proposition that the gain doesn't qualify for the Idaho capital gains deduction 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 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, [Redacted] owned an interest in a limited liability company. At the end of the day, [Redacted] had cash and a reduced interest in the limited liability company. At the end of the day, the LLC had the same real property that it did before the "distribution", "sale", and "contribution". The end result is exactly the same as if [Redacted] directly sold part of his membership interest to the new partner. The auditor cited the step transaction doctrine as the mechanism for the recharacterization of the transaction as a direct sale of [Redacted] interest in the LLC.

The petitioners' representative argues that the transactions in this case do not fall under the step transaction, and that the Commission has erred in applying this law. The representative states the Commission has erred for the following reasons.

> <u>Binding Commitment Test</u>: At the time of the distribution there was no binding commitment to sell the interest in the building. It was in their best interest and their intent to sell the interest in the building, but any one of them could have decided not to sell the building.
>
> <u>Mutual Interdependence Test:</u> The legal relationship created by transactions were not meaningless. Each step of the transaction was independent and any one of the partners at any time could have stopped, not completed the next leg of the transaction and held the asset in that manner. This did not happen because for management purposes only, all the individuals desired to hold the building together. Deeds to transfer the building were executed.
>
> <u>End Result Test</u>: Although it was a planned series of transactions, any individual at any time could have chosen to hold the property outside the LLC. There are also other ways this transaction could have been structured to accomplish the same results without distributing the building but selling it directly to the third party. Later, they then would have the option, if they desire to, to contribute it to the LLC or they could hold it and receive individual rents.

A review of the Purchase and Sale Agreement provided the following;

<u>Recital</u>

> B. [Redacted] liquidated 32.143 of the Sellers' voting units in [Redacted], being 1/7(14.28%) of the total membership interests, in proportion to their then existing membership interests, and distributed to Sellers an undivided 1/7 (14.28%) interest in [Redacted]s real property, for the purpose of transferring those interests to Buyer in order to facilitate his becoming an equal member of [Redacted].

<u>Agreement</u>

> 18. Post-Closing Obligations of Buyer. Immediately upon closing, Buyer must contribute the Real Property that is the subject of this Agreement to [Redacted] by Warranty Deed in exchange for receiving 32.143 membership/voting units in [Redacted]. If Buyer fails or refuses to make such contribution to [Redacted], this Agreement shall be null and void, and any conveyance of the Real Property from Sellers to Buyer shall likewise be null and void, and title to the Real Property shall revert back to Sellers upon their refund of the purchase price.

> 19. Post-Closing Obligations of Sellers. Sellers must approve and allow Buyer's contribution of the Real Property to [Redacted] in exchange for 32.143 membership/voting units in [Redacted], which represents a 1/7 (or 14.28%) ownership interest in [Redacted].

This language does not support the representative's argument.

In the first argument pertaining to the binding commitment test the representative states, "there was no binding commitment to sell the interest in the building….anyone of them could have decided not to sell the building." The agreement clearly indicates otherwise when it states, "for the purpose of transferring those interests to Buyer" and "Sellers must approve and allow Buyer's contribution..."

The representative argues "each step of the transaction was independent…." However, the agreement is in clear contrast to the mutual interdependence argument with its language, "Buyer must contribute the real property….and if Buyer fails or refuses to make such contribution."

The representative also disputes the application of the end result test, arguing that even though this case involved a planned series of transactions, there were other ways this transaction could have been structured to accomplish the same results. While there may have been other options for this transaction, the language unmistakably states the objective, "for the purpose of transferring those interests to Buyer in order to facilitate his becoming an equal member of [Redacted]."

It is well established that the "incidence of taxation depends upon the substance of a transaction" rather than its mere form. <u>Commissioner v. Court Holding Co.</u>, 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 <u>Gregory v. Helvering</u>, 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.

*   *   *

> 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).
>
> 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).

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

The taxpayer has the burden of proof with regard to deductions. They must show a provision allowing the deduction that they seek and show that they come within the bounds of such provision. New Colonial Ice Company, Inc. v. Helvering, 292 U.S. 435, 440 (1934).

If there is any ambiguity as to the law with regard to a deduction, the law is to be construed strongly against the taxpayer. Potlatch Corp. v. Idaho State Tax Commissionn, 128 Idaho 387, 913 P.2d 1157 (1996); Idaho State Tax Commssion v. Stang, 135 Idaho 800, 802 (2001).

The Commission finds that the asset conveyed is the partnership interest as stated in the Settlement and Purchase Agreement and, accordingly the gain here in question does not qualify for the Idaho capital gains deduction as determined by the auditor.

THEREFORE, the NODD dated November 17, 2011, is hereby APPROVED and MADE FINAL.

The petitioners are due a refund, plus interest in the following amount:

YEAR	REFUND	INTEREST	TOTAL
2010	($360)	($27)	($387)

Refund interest is calculated through March 15, 2013.

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

DATED this ________ day of ___________________ 2012.

IDAHO STATE TAX COMMISSION

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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.

[Redacted] _______________________________________