BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 24813
[Redacted],	)	
	)	
Petitioners.	)	DECISION
	)	

The petitioners protest the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated August 11, 2011. The Notice of Deficiency Determination (NODD) asserted additional liability for Idaho income tax, penalty, and interest in the total amount of $8,104 for 2007.

[Redacted] held an interest in a partnership. The partnership reported income and expenses regarding the rental of a building. The partnership had its offices in this building and depreciated the building on the partnership income tax returns. The title to the property was, at all times relevant to this matter, held in the names of the partners. After the passage of several years, the partners decided to sell the real property. Therefore, on August 31, 2007, they distributed undivided interests in the real property in liquidating distributions from the partnership. The property was then sold on the same day. The only question to be resolved is whether the gain from the disposition qualifies for the Idaho capital gains deduction. The auditor contends that the petitioners did not meet the required holding period for the property and, therefore, do not qualify for the deduction.

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;
>
> *   *   *
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> (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, <u>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</u> without regard to meeting the holding period. (Underlining added.)

If the sale in question is found to be the sale of a partnership interest (an intangible), the gain would not qualify for the Idaho capital gains deduction since the property disposed of would not be "qualified property." If the sale is found to be the sale of real property, the petitioners would need to show that they met the required 12 month holding period.

The petitioners contend that the liquidating distribution of the real property did not constitute an "exchange." Therefore, Idaho Code § 63-3022H(3)(f) does not apply.

The representative for the petitioners set out the appeal as follows:

> The taxpayer owned a commercial building with two other parties inside [Redacted]. This building was [sic] and rented to a [Redacted] from [Redacted]. When the [Redacted] dissolved, the partners decided to dispose of the building. Two of the three partners wanted to sell the building and keep their proceeds, the third partner wanted to defer any gain with a like-kind exchange of real estate for real estate. To accommodate this desire, the owners terminated the partnership and took an undivided interest in the real estate. The building was then sold.
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> The nature of the property sold was real estate as indicated on the closing statement attached. The partner's holding period includes the partnership's holding period and does not matter whether the property is received in a current or

> liquidating distribution – Code Section 735(b). Therefore, the real estate sale would qualify for long-term capital gain treatment.[1]
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> Internal Revenue Code § 735(b) states:
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> Holding period for distributed property.
> In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a)(2)), there shall be included the holding period of the partnership, <u>as determined under section 1223</u>, with respect to such property. (Underlining added.)

Accordingly, they contend that they have simply sold (qualifying) real property that includes the holding period of the partnership interest pursuant to Internal Revenue Code § 1223(1). Internal Code § 1223 stated, in part:

> Holding period of property. For purposes of this subtitle—
> (1) In determining the period for which the <u>taxpayer has held property received in an exchange</u>, there shall be included <u>the period for which he held the property exchanged</u> if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, <u>the same basis in whole or in part in his hands as the property exchanged</u>, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231 . For purposes of this paragraph—
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> > (A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and
> > (B) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.
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> (2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, <u>if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person</u>.

The distribution of the undivided interest in the real property was in exchange for the partnership interest held by the petitioners. Accordingly, for [Redacted] purposes, the holding period of the real property included the petitioners' holding period of the partnership interest.

[1] Letter from [Redacted] dated August 29, 2011.

While the holding period of the partnership interest is included for the purpose of [Redacted] taxation, this is not the case for purposes of the Idaho capital gains deduction. As stated above, Idaho Code § 63-3022H(3)(f) stated that, "[i]n 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, <u>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</u> without regard to meeting the holding period." (Underlining added.) Since the partnership interest (an intangible) was not "qualified property," the time that the partnership interest was held would not be included for purposes of determining whether the petitioners had met the holding period. Accordingly, the holding period of the land would be something less than one day which is not sufficient for the gain to qualify for the Idaho capital gains deduction.

This finding is also consistent with the step transaction doctrine. In addressing the step transaction doctrine, the Fifth Circuit Court of Appeals stated, in part:

> The step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form. See <u>Kuper v. Commissioner</u>, 533 F.2d 152, 155 (5th Cir.1976) (citing cases). Under the step transaction doctrine, "the tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan." <u>Crenshaw v. United States</u>, 450 F.2d 472, 475 (5th Cir.1971). When considered individually, each step in the series may well escape taxation. The individual tax significance of each step is irrelevant, however, if the steps when viewed as a whole amount to a single taxable transaction. Id. at 476. "[Taxpayers] cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status." Id. at 477.
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> The types of step transactions are as varied as the choreographer's art: there are two steps, waltzes, fox trots, and even Virginia reels. As a consequence, the courts' applications of the step transaction doctrine have been enigmatic. As the Seventh Circuit observed:

> The commentators have attempted to synthesize from judicial decisions several tests to determine whether the step transaction doctrine is applicable to a particular set of circumstances in order to combine a series of steps into one transaction for tax purposes. Unfortunately, these tests are notably abstruse-even for such an abstruse field as tax law.
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> Redding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir.1980), cert. denied, 450 U.S. 913, 101 S.Ct. 1353, 67 L.Ed.2d 338 (1981). Although no test seems to be universally accepted, it is possible to articulate several standards used by the courts in determining when and how to apply the step transaction doctrine. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations & Shareholders* supra, ¶ 14.51 (suggesting that different tests are applicable in different contexts).
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> The test most often invoked in connection with the application of the step transaction doctrine is the "end result" test. Under this test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct.Cl.1969). As the Fifth Circuit has noted, when cases involve "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result," the plans will be viewed as a whole "regardless of whether the effect of doing so is imposition of or relief from taxation." Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir.1954) (emphasis added). See also Kuper, 533 F.2d at 155-56; Crenshaw, 450 F.2d at 476; Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 658 (5th Cir.1968).

Security Industrial Insurance Company v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983).

At the beginning of the day, the petitioners held a partnership interest. At the end of the day, they had disposed of the partnership interest and had acquired money in return. As was stated by the petitioner, when the partnership dissolved, the desire was to dispose of the building.

The petitioners also argue that, since the real property was at no time deeded to the partnership, the sale was necessarily a sale of real property by the individual partners. It appears from the record before us that part of the real property was rented and that the rental income and related expenses were reported on the income tax returns filed on behalf of the partnership. It further appears that the property was depreciated by the partnership from the time of the purchase of the property.

In a case with similar facts, the U. S. Tax Court addressed the matter, in part, as follows:

> Throughout the life of the partnership, petitioner consistently represented to respondent that the ranch was partnership property. Petitioner did so by causing the partnership to file tax returns claiming depreciation deductions with respect to the ranch and by asserting the ranch was partnership property during audits of the partnership's Federal income tax returns. Consistent with the partnership's reporting position, petitioners filed individual Federal income tax returns for each of the taxable years 1982 through 1987 claiming petitioner's distributive loss from the partnership. The loss was calculated, in part, by deducting depreciation on ranch buildings and other improvements. When petitioners filed their Federal income tax return for 1988, however, they changed their representation with respect to the ranch, taking the position instead that the ranch was not partnership property and that the gain from the sale of the ranch was not income to them. Several years later, during the audit of the 1988 partnership return, petitioner failed to inform respondent that title to the ranch was held individually or that he had changed his prior reporting position that the ranch was partnership property.
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> These facts satisfy the three elements necessary to invoke the duty of consistency under Beltzer v. United States, 495 F.2d 211, 212 (8th Cir.1974). First, petitioner consistently represented that the ranch was partnership property, from the filing of the first partnership return to the filing of the partnership's final return. That representation carried over to petitioner's Federal income tax returns for 1982 through 1987. Second, respondent acquiesced in and relied upon these representations to respondent's detriment by allowing the period of limitations on assessment to run on petitioners' income tax returns without adjusting their distributive share of partnership income and deductions. See sec. 6501. Third, petitioner now claims that his previous representations were in error and seeks to change the representation on his 1988 Federal income tax return.
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> [8] Petitioners argue that the duty of consistency should not apply because they are innocent of any intentional wrongdoing. They contend that they did not learn that title to the ranch was held individually until after the period of limitations had run. This defense is without merit because the duty of consistency applies equally to a taxpayer who innocently misrepresents a fact in a time-barred year and one who misleads intentionally. See Beltzer v. United States, supra at 212; Unvert v. Commissioner, 72 T .C. 807, 816, 1979 WL 3842 (1979), affd. 656 F.2d 483 (9th Cir.1981). (Footnote omitted.)
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> Petitioners also argue that the duty of consistency does not apply because whether they own a property interest for Federal tax purposes is controlled by State law [footnote omitted]. We reject this argument. Determining whether the ranch was

> owned by the partners as individuals or by the partnership is simply not necessary to our decision regarding the duty of consistency. The duty of consistency is an affirmative defense grounded in equity and is designed to prevent taxpayers from changing a tax-significant representation benefiting the taxpayer at a time when the Commissioner is prevented by law from correcting the taxpayer's tax reporting position based on that representation. We need not decide whether the representation in question is true or false in order to decide whether petitioners are bound by the duty of consistency. We need only decide if petitioners are attempting to change a representation for tax purposes after respondent has relied on that representation and the applicable period of limitations has expired. The duty of consistency applies even if the original representation is erroneous, as long as respondent demonstrates that the three elements necessary to invoke the duty of consistency have been satisfied. See Herrington v. Commissioner, 854 F.2d 755, 757 (5th Cir.1988), affg. Glass v. Commissioner, 87 T.C. 1087, 1986 WL 22053 (1986). In this case, once we determine that the duty of consistency applies, we no longer care who actually owned the ranch since, for Federal income tax purposes, the duty of consistency requires petitioners to be bound by their prior representations regarding the ranch's ownership. For this reason, we need not and do not decide who actually owned the ranch or whether State law applies in deciding that issue.
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> On these facts, we hold that the duty of consistency applies, and, therefore, petitioners are estopped from claiming that the ranch was not partnership property at the time of its sale in 1988.
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> Hollen v. Commissioner, T.C. Memo. 2000-99.

The Commission finds that the petitioners are bound by the duty of consistency to treat the property as having been the property of the partnership. Further, the Commission finds that the petitioners have failed to meet the holding period of one year and, therefore, are not entitled to the Idaho capitals gains deduction with regard to this transaction.

THEREFORE, the Notice of Deficiency Determination dated August 11, 2011, 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 November 30, 2014):

YEAR	TAX	PENALTY	INTEREST	TOTAL
2007	$6,574	$329	$1,951	$8,854

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 ___________________ 2014.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of ___________________ 2014, 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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