BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted], Petitioners.	))))))	DOCKET NO. 25098 DECISION

[Redacted] (petitioners) protested the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated May 11, 2012. The Notice of Deficiency Determination (NODD) asserted additional liability for Idaho income tax, penalty, and interest in the total amounts of $5,230, $11,392, and $54,353 for 2008, 2009 and 2010, respectively.

There are four issues to be resolved in this docket:

1. is the loss generated from the disposition of certain real property a capital loss or an ordinary loss,
2. should the loss claimed with regard to issue 1 have been greater due to having a higher basis in the property than claimed,
3. does the gain from the disposition of a partnership interest qualify for the Idaho capital gains deduction, and
4. should a capital loss claimed by the petitioners in 2009 have been claimed in 2010 rather than in 2009?

The first issue in this docket relates to the purchase and subsequent deed in lieu of foreclosure of two adjacent parcels of real estate. The first such lot was purchased on June 12, 2007. The adjacent lot was purchased on July 30, 2007. They were held until March 18, 2010, at which time the bank took title to the properties. The question to be resolved is whether the loss from the disposition of the two parcels produced an ordinary loss or a capital loss. The petitioners contend that the loss is an ordinary loss. The auditor contends that the loss is a capital loss.

Different courts have set out different tests to decide whether the property in question is held for sale to customers in the ordinary course of business. All of the sets of tests seek to weigh the various fact patterns to determine whether the property was held for sale to customers in the ordinary course of their business. With regard to cases determining whether a gain or loss from property is capital or ordinary in nature, the Fifth Circuit Court of Appeals stated, in part:

> Thus matters remain, in our Circuit, essentially where the now-famous [footnote omitted] passage from an earlier edition of Mertens, commenting on 'Capital Gains: Dealer v. Investor Problems,' left them: 'If a client asks in any but an extreme case whether, in your opinion, his sale will result in capital gain, your answer should probably be, 'I don't know, and no one else in town can tell you.' The difficulty, however, is inherent in the nature of the thing itself, and does not lie in judicial perversity or a delight in being obscure. Results cannot be casually predictable where so many variables are present and so many factors of judgment must be exerted. Extreme cases will be clear, but those who elect to sail close to the wind must take their chances.

Biedenharn Realty Company, Inc. v. United States, 509 F.2d 171, 175 (5th Cir. 1975).

In Biedenharn Realty, there were 37 sales in the three years before the court. In the panel decision first rendered by the Fifth Circuit Court of Appeals, the finding was that the sales were not sales of property held for sale in the ordinary course of the taxpayer's business. On rehearing the case En Banc, the court reversed its earlier decision and found that the sales were not capital in nature, but ordinary.

The Fifth Circuit Court of Appeals set out the questions to be answered as follows:

> In the context of cases like the one before us, the principal inquiries demanded by the statute are:
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> 1) was taxpayer engaged in a trade or business, and, if so, what business?
> 2) was taxpayer holding the property primarily for sale in that business?
> 3) were the sales contemplated by taxpayer "ordinary" in the course of that business?

Suburban Realty Company v. United States, 615 F.2d 171, 178 (5th Cir. 1980).

[Redacted] holds an [Redacted] license and specializes in [Redacted] [Redacted]. He also held 45 percent to 50 percent interest in a realty agency. During 2007 and 2008, the realty firm operated as a subchapter S corporation. During the years thereafter, it was a limited liability company. [Redacted] was not a realtor. Clearly, [Redacted] was in the business of [Redacted]. However, one can be in more than one business. S & H, Inc. v. Commissioner, 78 T.C. 234, 243 (1982); Curphey v. Commissioner, 73 T.C. 766, 775 (1980).

The petitioners allege that at some time or times, the property here in question was listed for sale with the realty firm. The times and listing prices were not submitted as evidence by the petitioner. Therefore, the Commission has only the petitioners' self-serving statement to support this point.

If [Redacted] was in the business of selling real estate, was the "sale" (the deed in lieu of foreclosure) in this case "ordinary" in the course of that business? The petitioners have not asserted that this is so.

The proportion of the taxpayer's income from real estate as compared to all of his income has been deemed relevant to the determination of whether the taxpayer is in the business of real estate. See Biedenharn Realty Company, Inc. v. United States, 526 F.2d 409 (5th Cir. 1976). The gain or loss from the sales of real estate or a partnership in which real estate was held is as follows:

	GAIN/LOSS FROM REAL ESTATE	ADJUSTED GROSS INCOME
2006	$ 76,881	$1,225,287
2007	0	414,937
2008	0	164,948
2009	211,884	876,330
2010	(551,741)	253,685
	$(262,976)	$2,935,187

The frequency of a taxpayer's realty purchases and sales is an important factor in determining whether a gain or loss from the sales should be treated as capital or ordinary. Frankenstein v. Commissioner, 31 T.C. 431 (1958). With respect to this, the Fifth Circuit Court of Appeals stated:

> In the principal recent cases, there has always been a conjunction of frequent and substantial sales with development activity relating to the properties in dispute. See, e. g., Houston Endowment, Inc. v. United States, 606 F.2d 77, 82 (5th Cir. 1979), Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409, 417 (5th Cir.) (en banc), cert. denied, 429 U.S. 819, 97 S.Ct. 64, 526 F.2d at 417; United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969). The conjunction of these two factors "will usually conclude the capital gains issue against (the) taxpayer." Biedenharn, 526 F.2d at 418. Judge Wisdom has recently written that "ordinary income tax rates usually apply when dispositions of subdivided property over a period of time are continuous and substantial rather than few and isolated." Houston Endowment, 606 F.2d at 81. Also, it has been explicitly stated that the factor which will receive greatest emphasis is frequency and substantiality of sales over an extended time period. See Biedenharn, 526 F.2d at 417.
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> Suburban Realty Company v. United States, 615 F.2d 171, 176 (5th Cir. 1980).

In this case, the sales were infrequent. In 2006, the petitioners sold one lot. In 2009, the petitioners sold two interests in partnerships which held real property. We also have the deed in lieu of foreclosure of the property here in question in 2010. The infrequency of sales is not always determinative of the character of the gain or loss. S & H, Inc. v. Commissioner, 78 T.C. 234 (1957). In S & H, the taxpayer had built a warehouse on the property for a cost of more than $2,000,000 and had agreed to the sale of the property upon completion prior to building the warehouse. Therefore, there were substantial improvements made to said property.

In reviewing the treatment afforded by the petitioners in prior years, we find that they did not report their transactions in real estate as if they were in the trade or business of selling real property. Property taxes relating to the holding of the property in question were apparently deducted on Schedule A (as an itemized deduction) prior to the year of the sale of the property, not on a Schedule C as having been incurred in a trade or business. For the sales of property in 2006 and (the partnership interests) in 2009, the petitioners reported the gains on Schedule D and claimed the Idaho capital gains deduction. This is not consistent with being in the "business" of selling real estate. The petitioners did not file a Schedule C (Profit or Loss from Business) for [Redacted] activity in real estate prior to 2010 (to reflect the loss from the repossession of this property). *See* Zurcher v. Commissioner, T.C. Memo 1997-203.

The venture here before the Commission is a single speculative venture. The petitioners purchased the two adjacent properties and intended to remove an easement from the property and sell the property at a profit. In addressing a single speculative venture, the Fifth Circuit Court of appeals stated, in part:

> It is contended by Williams that when the company by whom he was employed declined to take the vessel the efforts, and their culmination, in disposing of the vessel were by way of liquidation. As a liquidating venture, says Williams, capital gains treatment of the profit was in order. Reliance is placed upon United States v. Robinson, 5 Cir., 1942, 129 F.2d 297, Fahs v. Crawford, 5 Cir., 1947, 161 F.2d 315, and Smith v. Commissioner, 5 Cir., 1956, 232 F.2d 142. For the Commissioner it is asserted that Williams' intent to liquidate is not the issue, and that we are concerned with the nature of the income to the partnership. The Commissioner stresses the Tax Court's statement that 'Nothing in the evidence is contrary to the idea that it (the partnership) acquired the property and held it for the primary purpose of sale.' The partnership agreement recited a partnership purpose 'of carrying on the business of buying, constructing, completing, equipping, selling, hiring, leasing, chartering and operating ships and vessels of all kinds and character, specifically including tankships.' However, the exercise of a power and not the possession of it is the material factor to be weighed in determining whether or not a particular activity or transaction is in the ordinary course of trade or business. Alabama Mineral Land Co. v. Commissioner, 5 Cir., 1957, 250 F.2d 870. No evidence indicates that any other ship purchases by the partnership were contemplated. A partnership organized to dispose of a single property is not operating a business of selling property of such kind and character. Guggenheimer v. Commissioner, 2 Cir., 1954, 209 F.2d 362. Fidler v. Commissioner, 9 Cir., 1956, 231 F.2d 138. We are in accord with the Tax Court's findings that the vessel was acquired, both by Williams and by Marine Industries, for the purpose of sale and it was held for sale at the time it was sold. This does not necessarily mean that the property was sold while being held for sale in the ordinary course of trade or business. Thomas v. Commissioner, 5 Cir., 1958, 254 F.2d 233. The purchase and sale of the vessel was a non-recurring speculative venture and the transactions of its acquisition and disposition did not constitute a trade or business of either Williams or the partnership, Marine Industries.

> Thomas v. Commissioner, supra. The tankship was a capital asset and it was not held primarily for sale to customers in the ordinary course of trade or business.
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> Commissioner v. Williams, 256 F.2d 152, 154-155 (5^{th} Cir. 1958).

The Commission finds that [Redacted] was not in the "business" of selling real estate. Accordingly, this adjustment made by the auditor must be affirmed.

ISSUE 2.

In the petitioners' letter of protest, they stated that [Redacted] was incorrectly omitted from the calculation of the basis used to calculate the loss on the disposition of the two adjacent parcels. The Commission finds that this adjustment to the basis of the property should be made.

ISSUE 3

The petitioners contend that they are entitled to an Idaho capital gains deduction with regard to the disposition of an interest in land. The auditor contends that the petitioners sold an interest in a partnership and that, as such, the gain is not eligible for the deduction sought. The petitioners originally reported the installment sale as a partnership interest. The petitioners were invited to produce evidence that they directly owned the property in question. However, they have failed to produce any such evidence. The Commission has ruled on several occasions that a partnership interest is not eligible for this deduction.

Idaho Code § 63-3022H sets out the authority for the allowance of the Idaho capital gains deduction. It stated [2009], in part:

> (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;
> (b) Tangible personal property used in Idaho for at least twelve (12) months by a revenue-producing enterprise;
> (c) Cattle or horses held for breeding, draft, dairy or sporting purposes for at least twenty-four (24) months if more than one-half (1/2) of the taxpayer's gross

income (as defined in section 61(a) of the Internal Revenue Code) for the taxable year is from farming or ranching operations in Idaho;
(d) Breeding livestock other than cattle or horses held at least twelve (12) months if more than one-half (1/2) of the taxpayer's gross income (as defined in section 61(a) of the Internal Revenue Code) for the taxable year is from farming or ranching operations in Idaho;
(e) Timber grown in Idaho and held at least twenty-four (24) months;

The U. S. Supreme Court has stated, in part:

[Connecticut Succession and Transfer Act] A partner has a right equal to that of his partners to possess specific partnership property for partnership purposes, but not otherwise. His right in specific partnership property is not assignable, nor is it subject to attachment or execution upon a personal claim against him; upon his death the right to the specific property vests not in the partner's personal representative but in the surviving partner; his right in specific property is not subject to dower, curtesy, or allowance to widows, heirs or next of kin.

Section 52 specifically provides:

'A partner's interest in the partnership is his share of the profits and surplus and the same is personal property.'

Under section 73, when any partner dies and the partnership continues, his personal representative may have the value of his interest at the date of dissolution ascertained and receive as an ordinary creditor an amount equal to the value of his interest in the partnership with interest.

Under section 98, c. 640, Laws of 1922, the rights of a general partner in a limited partnership, which was the interest of the decedent here when he died, are identical with those of a general partner in a general partnership. And in regard to a limited partner's interest, section 107 of the law specifically provides:

'A limited partner's interest in the partnership is personal property.'

It is very plain, therefore, that the interest of the decedent in the partnership of William Openhym & Sons was simply a right to share in what would remain of the partnership assets after its liabilities were satisfied. It was merely an interest in the surplus, a chose in action. It is an intangible, and carries with it a right to an accounting.

There were among the holdings and property of the partnership buildings and land. Although these statutes were passed after the decision in Darrow v. Calkins, 154 N. Y. 503, 49 N. E. 61, 48 L. R. A. 299, 61 Am. St. Rep. 637, we have no reason for thinking that the partnership law of New York is now any different from what its Court of Appeals said it was in that case (pages 515, 516 (49 N. E. 64)) as follows:

> 'It is, however, generally conceded that the question whether partnership real estate shall be deemed absolutely converted into personalty for all purposes, or only converted pro tanto for the purpose of partnership equities, may be controlled by the express or implied agreement of the partners themselves, and that where by such agreement it appears that it was the intention of the partners that the lands should be treated and administered as personalty for all purposes, effect will be given thereto. In respect to real estate purchased for partnership purposes with partnership funds and used in the prosecution of the partnership business, the English rule of 'out and out' conversion may be regarded as properly applied on the ground of intention, even in jurisdictions which have not adopted that rule as applied to partnership real estate acquired under different circumstances and where no specific intention appeared. The investment of partnership funds in lands and chattels for the purpose of a partnership business, the fact that the two species of property are in most cases of this kind, so commingled that they cannot be separated without impairing the value of each, has been deemed to justify the inference that under such circumstances the lands as well as the chattels were intended by the partners to constitute a part of the partnership stock and that both together should take the character of personalty for all purposes, and Judge Denio in Collumb v. Read (24 N. Y. 505), expressed the opinion that to this extent the English rule of conversion prevailed here. That paramount consideration should be given to the intention of the partners when ascertained, is conceded by most of the cases.'
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> Blodgett v. Silberman, 277 U. S. 1, 10-12 (1928).

Idaho Code § 53-3-501 states:

> Partner not co-owner of partnership property. – A partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily.

Idaho Code § 53-3-502 states:

> Partner's transferable interest in partnership. – The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. The interest is personal property.

The petitioners contend that they sold real property. The record before us indicates that the asset conveyed was a partnership interest which, according to Idaho law, is clearly personal property regardless of the nature of the assets in the partnership. The Commission further finds that the partnership interest is an intangible asset pursuant to Blodgett. *See* Citron v. Commissioner, 97 T.C. 200, 209–210 (1991); Milton v. Commissioner, T.C. Memo 2009-246. Accordingly, the

Commission finds that the petitioners are not entitled to the Idaho capital gains deduction with regard to this gain.

ISSUE 4

The petitioners contend that a capital gain reported on their 2009 return should have been reported on their 2010 return. Property sold by a partnership in which they held an interest was sold in December of 2009. Payment for the property was not received by their agent until January 4, 2010. Since the accounting method used by the partnership was cash basis, the sale should have been reported in 2010.

THEREFORE, the Notice of Deficiency Determination dated May 11, 2012, is hereby MODIFIED, and as so modified is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax, penalty, and interest (computed to June 30, 2014):

YEAR	TAX	PENALTY	INTEREST	TOTAL
2008	$ 4,364	$ 218	$ 941	$ 5,523
2009	(6,609)		(1,094)	(7,623)
2010	65,886	3,294	7,803	76,983
				$74,803

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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