

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 26101
[Redacted],)	
)	
Petitioners.)	DECISION
_____)	

[Redacted] (Taxpayers) protested a Notice of Deficiency Determination (NODD) issued by the Idaho State Tax Commission (Commission) on April 12, 2013. The NODD made adjustments to taxable years 2008, 2009, 2010, and 2011.

The Commission received Taxpayers’ protest on June 12, 2013, and reviewed the relevant information contained in this file. Because the home sold in 2008 was constructed in the ordinary course of the Taxpayers’ business and Taxpayers’ protest letter and subsequent correspondence did not provide sufficient information to modify the expense and income adjustments, the Commission affirms the NODD issued on April 12, 2013.

FACTS

A. The sale of real property and the Idaho capital gains deduction.

In 1996, Taxpayers purchased land in [Redacted], Idaho for \$15,096 and held it unimproved until 2006. In June 2006, Taxpayers and Taxpayers’ sister, Ms. [Redacted] (hereafter referred to as Buyer), jointly created [Redacted]. [Redacted] obtained a permit to construct residential family dwellings. In September 2006, [Redacted] began construction of a home on the Taxpayers’ land. The specific timeframe is unclear because the Taxpayers have not produced the construction contract, but at some point before November 2007, [Redacted] signed a contract with Buyer to build the home to Buyer’s specifications. The total purchase price for the home and the land was \$321,194. Buyer financed the majority through a commercial

financial institution, paid some cash, and issued a promissory note to [Redacted] for \$115,000. The sale closed after the home was completed on February 29, 2008.

After selling the home in 2008, Taxpayers reported \$130,746 of income, and all but \$21,840 (wages earned by [Redacted]) was from the sale of real estate. While Taxpayers only reported income from the sale of real estate in taxable year 2008, Taxpayers reported expenses relating to the work done on the home from 2006 to 2008, which shows they had been working on the home for two years prior to the sale.

Taxpayers assert that [Redacted] was in the business of remodeling homes and that the construction of a new home was not an ordinary business activity. Taxpayers claim this is evident because [Redacted] has been solely owned by Taxpayers since Buyer left the company in 2008, has no employees, and holds itself out to the public as a [Redacted] company. The Bureau was not persuaded and re-characterized the income from the sale of the home as ordinary.

In taxable year 2008, Taxpayers also claimed an Idaho capital gains deduction in the amount of \$85,069 on the sale of the home. Since the Bureau characterized the gain as ordinary, it did not qualify for the deduction. The Bureau disallowed the deduction.

In taxable year 2010, Buyer defaulted on the \$115,000 note used to purchase the home. Taxpayers claimed a short-term capital loss and carried forward the capital loss to taxable year 2011. The Bureau re-characterized the note as bad business debt that offset ordinary income in taxable year 2010 and resulted in a net operating loss that carried back to taxable year 2008 to offset income from the sale of the home.

B. Business Expenses

In taxable year 2008, [Redacted] began improving residences owned by other people and continued this activity in taxable year 2009. Taxpayers reported income and expenses from this activity on Schedules C for both years. They also provided some documentation, including accounting records, supporting many items of gross receipts and expenses. Taxpayers have not provided documentation in support of several claimed expenses including the use of vehicles, cell phones, meals, and entertainment. The Bureau notified Taxpayers of the requirement to substantiate these expenses and disallowed the deductions.

C. Excludable Transactions

Taxpayers provided receipts in the amounts of \$31,481 for proceeds from the sale of assets, \$1,700 for laminate flooring, and \$400 for materials. Taxpayers assert that these were the result of the sale of assets. The assets sold were not identified or substantiated and the Bureau added them to income in their respective taxable years.

D. Payment for Work

Taxpayers provided a receipt from 2008 showing that they received \$30,000 described as “payment for work.” Taxpayers assert that this was a deposit for work to be done in a future year but provided no documentation to aid that assertion. The Bureau determined that Taxpayers are on the cash method and that deposits for work to be done in a future year are taxable in the year received. The Bureau added the payment to income in taxable year 2008.

LAW AND ANALYSIS

A. The Sale of Real Property

The sale of the property in taxable year 2008 resulted in ordinary income because it was in the ordinary course of business for [Redacted]. The Internal Revenue Code (IRC) defines

ordinary income by exclusion as “any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).” IRC § 64. The IRC defines a capital asset and § 1231 property also by exclusion as not including “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” IRC § 1221(exact language in § 1231(b)).

The court in Suburban Realty Co. v U.S. found that three questions must be answered to determine whether property is held “primarily for sale to customers in the ordinary course of his trade or business.” These questions are:

- 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 Co. v. United States, 615 F.2d 171, 178 (5th Cir. 1980).

1) Whether the Development and Sale of Real Estate is Part of Taxpayers’ Business

There is no question that Taxpayers were engaged in a trade or business, the only question is whether the development and sale of real estate is a part of that business. The courts point to seven factors to help determine whether a taxpayer is in the business of selling real estate:

- (1) the nature and purpose of the acquisition of the property and the duration of the ownership;
- (2) the extent and nature of the taxpayer’s efforts to sell the property;
- (3) the number, extent, continuity and substantiality of the sales;
- (4) the extent of subdividing, developing, and advertising to increase sales;
- (5) the use of a business office for the sale of the property;
- (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property;
- and (7) the time and effort the taxpayer habitually devoted to the sales.

United States v. Winthrop, 417 F.2d 905, 909-10 (5th Cir. 1969).

An analysis of these factors and a weighing of the test in its entirety tend to show that [Redacted] was in the business of selling real estate. The factors in favor of finding that

[Redacted] was in the business of selling real estate are the nature and purpose of the acquisition of the property, the extent of developing the property, and the time and effort Taxpayer devoted to the sale.

First, Taxpayers assert their intention when they acquired the property in 1996 was to build their own home on the property, and they held the property unimproved until 2006. But their intention changed when they began construction on a home under a sales contract for its eventual sale in taxable year 2008.

Second, the sale of the home accounted for substantially all of [Redacted] profits from taxable year 2006 to taxable year 2008.

Third, Taxpayers created [Redacted] in taxable year 2006. [Redacted] obtained a license from the Idaho Bureau of Occupational Licenses to build residential single family dwellings and spent the next two years building a residential single family dwelling to the specifications of Buyer.

Fourth, through [Redacted], Taxpayers spent two years developing the property in question and all of that was for the purpose of its eventual sale.

In addition to these factors, Taxpayers reported on Schedules C for 2008 and 2009 that [Redacted] principal business was residential building. At least for the years of 2006 to 2008, Taxpayers were engaged in the business of developing and selling real estate.

These factors must be weighed against those that tend to show that [Redacted] was not in the business of selling real estate. Those factors are that Taxpayers only sold one home, did not advertise and did not have a business office. However, after weighing all of the factors together, the Tax Commission finds that [Redacted] was engaged in the business of selling real estate.

2) Whether Taxpayer was holding the property primarily for sale in that business

Taxpayers assert that their original intention when they bought the property in question was to eventually build a home for themselves on the property. However, the intent at the time property is sold, not at the time it is acquired, governs the character of the gain. Klarkowski, Stanley v. Commissioner, 385 F.2d 398 (7th Circuit 1967). Regardless of Taxpayers' purpose for acquiring the land, their purpose for holding the land from 2006 to 2008 was solely to develop it for sale to a contracted party through their business [Redacted].

Since Taxpayers never produced the contract, it is not possible to pinpoint the exact date that Taxpayers' intent changed or when the home was officially under contract for sale. But the facts support the conclusion that the contract for sale was initiated before building began. First, Buyer was a member of the LLC from its inception and resigned as a member in the year the home was completed. The fact that Buyer was a member of the LLC when building began and left immediately after the home was complete is evidence that Buyer's sole purpose for entering the LLC was to oversee the building of the home they would eventually purchase. Since Buyer joined the LLC solely to oversee the construction of the home, it is likely the home was built under contract from the beginning. Second, Taxpayers produced an addendum to the contract that was signed in November 2007, meaning the contract existed before then. Third, Taxpayers created the LLC before beginning construction. If Taxpayers started building the home for themselves, they would not likely need to create an LLC to oversee the construction.

These facts make it more likely than not that Taxpayers developed the intention to sell the home and created a contract for that sale before beginning construction.

3) Whether the sale was “in the ordinary course” of Taxpayers’ business

The Winthrop case again provides guidance in answering this question:

The concept of normalcy requires for its application a chronology and a history to determine if the sales of lots to customers were the usual or a departure from the norm.

United States v. Winthrop, 417 F.2d 905, 912 (5th Cir. 1969)

In 2006, [Redacted] registered as a contractor with the Idaho Bureau of Occupational Licenses and obtained a permit to construct residential single family dwellings. It was only after [Redacted] completed the construction of the home that it started remodeling residential homes. Additionally, Taxpayers created [Redacted] as an LLC. Buyer and (Taxpayers) were the LLC’s only members. Because [Redacted] is listed as the seller on the title settlement, it is clear that at some point Taxpayers transferred the property to [Redacted] and formed the business for the purpose of developing and selling this property. Thus, the sale was in the ordinary course of the newly formed business.

Because Taxpayers developed and sold the home in the ordinary course of Taxpayers’ business it cannot be considered a capital asset under IRC § 1221 or § 1231. Therefore, the sale of the property results in ordinary income. IRC §§ 64, 1221, 1231. Since this income is ordinary, it does not qualify for the Idaho capital gains deduction.

Additionally, Taxpayers obtained the \$115,000 note from Buyer in this same transaction, which was in the ordinary course of business. Thus, the eventual default should be characterized as bad business debt resulting in a net operating loss (NOL) in 2010. The NOL should be carried back and absorbed against ordinary business income in 2008.

Also, the short term capital loss that was reported in 2010 and carried forward in 2011 is disallowed because the default resulted in an ordinary loss.

B. Business Expenses

IRC § 274(d) states that no deduction shall be allowed for meals and lodging or with respect to any property listed in IRC § 280F(d)(4) (includes any passenger vehicle and cell phones) “unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer’s own statement.” To substantiate the deduction of these items, Taxpayers must provide information such as the amount of each separate expenditure, the dates they were incurred, the destination or location, and the business reason for the expenditure. Treasury Reg. § 1.274-5T(b). Taxpayers deducted expenses pertaining to meals, lodging, cell phones, and vehicles, yet failed to substantiate the deductions with adequate records. Due to the lack of substantiation, these deductions are disallowed.

C. Excludable Transactions

Taxpayers received \$31,481, \$1,700, and \$400 for the sale of “assets,” “laminated flooring,” and “materials” respectively, but failed to identify the property sold in each of these transactions. If the property cannot be identified, it cannot be attributed a basis. Receipts on its sale must be included in income. IRC § 1012.

D. Payment for Work

Under the cash method of accounting, income is reported when cash is actually or constructively received. Treasury Reg. § 1.461-1(a). Taxpayers established themselves as cash-method taxpayers by including receipts in income as opposed to accounting for income as it was earned. In 2008, Taxpayers received \$30,000 described as “payment for work” that was not reported as income. Taxpayers contend that this was a deposit for work to be performed in the future. Taxpayers did not show that the deposit was returned, is expected to be returned, or was

reported in a proximate year. Since Taxpayers are on the cash method and the money was actually received in 2008, the receipt is included in income in 2008.

CONCLUSION

The Commission finds: 1) the character of income received from the sale of the home in 2008 is ordinary, the default on the note resulted in bad business debt and a net operating loss in 2010, and no capital loss occurred in ,2010 so no capital loss should be carried forward to 2011, 2) the business expense deductions for vehicles, cell phones, meals, and entertainment were unsubstantiated and not deductible, 3) income from the sale of assets was not excludable because the assets were not identified or attributed a basis, and 4) Taxpayers are cash-method taxpayers, which makes income reportable in the year the funds were received. For these reasons, the Commission affirms the NODD in its entirety.

THEREFORE, the Notice of Deficiency Determination dated April 12, 2013, and directed to [Redacted], is hereby AFFIRMED.

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

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2008	\$8,354	\$1,253	\$1,858	\$11,465
2009	1,424	71	252	1,747
2010	(400)	0	(46)	(446)
2011	228	11	17	<u>256</u>
			TOTAL DUE	<u>\$13,022</u>

Interest for the above deficiency is calculated through September 1, 2014.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

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

DATED this _____ day of _____ 2014.

IDAHO STATE TAX COMMISSION

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.
