

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
[Redacted])	DOCKET NO. 1-605-515-264
)	
Petitioner.)	DECISION
_____)	

The Idaho State Tax Commission (Commission) reviewed your case and this is our final decision. We uphold the Notice of Deficiency Determination (Notice) dated January 30, 2018. This means **you need to pay \$1,080,728** of tax, penalty and interest for taxable year 2015. The Commission now demands immediate payment of this amount.

[Redacted] (Petitioner) was an Idaho resident in taxable year 2015. He timely filed an Idaho individual income tax return for this year, claiming an Idaho capital gains deduction.

[Redacted] owned 30.939% of the stock in [Redacted] (an S Corporation) and was the grantor of the [Redacted] 2013 Family Irrevocable Trust, which owned 2.974901% of [Redacted]. In 2015, [Redacted] entered into a stock purchase agreement with [Redacted] LP in which [Redacted] sold a majority interest (66.67%) in its wholly owned subsidiary, [Redacted]. The capital gain from the sale of this stock flowed through to the shareholders of [Redacted] including Petitioner. Petitioner reported this gain on his 2015 Idaho individual income tax return and claimed the Idaho capital gains deduction.

The auditor disallowed the Idaho capital gains deduction. Whether Petitioner is entitled to this deduction is the sole issue to be decided in this decision.

Idaho Code § 63-3022H sets forth the authority for the deduction sought. It states, in pertinent part [2015]:

Deduction of Capital Gains

(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;
- (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, 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 without regard to meeting the holding period nor shall the holding period include any time period in which the property subject to this section was held by a corporation other than an S corporation. Notwithstanding the preceding sentence, the holding period of qualifying property that was distributed by an S corporation or an entity treated as a partnership to a person who was an owner, member or partner at the time of the distribution shall, for that person, include the amount of time that the S corporation or the entity held the property, regardless of whether the distribution was a liquidating distribution;
- (g) When cattle, horses or breeding livestock were held and then sold by a pass-through entity, the requirement in paragraphs (c) and (d) of this subsection, that more than one-half (1/2) of the taxpayer’s gross income for the taxable year be from farming or ranching operations in Idaho, shall apply to the activities of the pass-through entity. If more than one-half (1/2) of the pass-through entity’s gross income for the taxable year was from farming or ranching operations in Idaho, and the other requirements of this section are satisfied, then the capital gains deduction is available to the individual owners of an interest in the pass-through entity on their distributive share of

the proceeds from the cattle, horse or breeding livestock sale.

(4) As used in this section “revenue-producing enterprise” means:

- (a) The production, assembly, fabrication, manufacture, or processing of any agricultural, mineral or manufactured product;
- (b) The storage, warehousing, distribution, or sale at wholesale of any products of agriculture, mining or manufacturing;
- (c) The feeding of livestock at a feedlot;
- (d) The operation of laboratories or other facilities for scientific, agricultural, animal husbandry, or industrial research, development, or testing.

(5) As used in this section the term “real property” means land and includes the following:

- (a) A “qualified conservation easement,” as defined in section 2031(c)(8)(B) of the Internal Revenue Code, conveyed to a “Qualified Organization” as defined in section 170(h) of the Internal Revenue Code;
 - (b) Grazing permits or leases issued by the U.S. forest service, the bureau of land management or the Idaho department of lands, if such permit is transferred simultaneously with the transfer of the “base property”; and
 - (c) Any other property defined in section 1250(c) of the Internal Revenue Code as “section 1250 property” conveyed in perpetuity, the transfer of which would be required to be in writing by section 9-503, Idaho Code.
- (6) Property that has been depreciated pursuant to section 1245 of the Internal Revenue Code is not eligible to be treated as real property for purposes of this deduction.

Idaho Code § 63-3022H, 2015

Idaho Income Tax Administrative Rule 171.05 gives further clarification of non-qualifying property. Nonqualifying property includes:

- a. Real or tangible property not having an Idaho situs.
- b. Tangible personal property not used by a revenue-producing enterprise.
- c. Intangible property. Some examples of intangible property include, but are not limited to:
 - i. **Stocks and bonds**;(emphasis added)
 - ii. Easements and rights of way, including agricultural, forest, historic, or open-space easements;
 - iii. Grazing permits

In the present matter, the auditor disallowed the Idaho capital gains deduction in 2015 asserting that the sale of stock, an intangible asset, is not the sale of qualifying real property.

Petitioner protested the Notice with the following objections:

[Redacted] is a scientific research facility as evidenced by the allowable credit for research activity taken on Form 6765 “Credit for Increasing Research Activities” of the [Redacted] 2015 Federal tax return Form 1120S. Furthermore, the credit for Idaho Research Activities was allowed in Idaho’s Audit explanation #8, Credit for Idaho Research Activities. The sale of assets included property that is not specifically identified as a nonqualifying asset in the Idaho regulations and is typical property for a scientific and research and development revenue producing enterprise. The property was located in Idaho and held for more than a 12-month period and again not specifically identified as a nonqualifying property so should therefore be qualifying property for the purpose of the 60% capital gains deduction.

The Commission agrees [Redacted] is a revenue-producing enterprise. However, Petitioner’s capital gain was not a result of the sale of the assets of [Redacted] but rather the sale of stock in [Redacted]. According to the Stock Purchase Agreement and Closing Financial Certificate dated December 11, 2015, Petitioner sold his shares of [Redacted] stock, which generated the capital gain. Therefore, the fact that [Redacted] is a revenue-producing enterprise is irrelevant, Petitioner did not sell qualifying property. What Petitioner sold was stock, an intangible asset. No provision in Idaho Code § 63-3002H (3) provides for a capital gains deduction with regard to a gain from the disposition of an intangible asset. Accordingly, the Commission finds that Petitioner is not entitled to the deduction sought.

Petitioner also objects to the penalties and interest proposed in the Notice, requesting they be waived for cause claiming that there is insufficient clarification in Idaho regulations regarding the capital gains exclusion as it applies to revenue producing enterprises. The Commission disagrees. The Idaho Code and supporting Administrative Rule related to the Idaho capital gains deduction and the sale of stock are clear. In addition, the instructions for Idaho Form CG, which

are used to compute an individual's Idaho capital gain deduction, state in bold type, **NOTE: Gains from the sale of stocks and other intangibles don't qualify.**

The Notice issued to Petitioner proposes both the negligence penalty and the substantial understatement penalty. Idaho Code § 63-3046(a) states:

If any part of any deficiency is due to negligence or disregard of rules but without intent to defraud, five percent (5%) of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency.

Idaho Code § 63-3046(d) states in part:

- (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent (10%) of the amount of any underpayment attributable to such understatement.
- (2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
 - (i) Ten percent (10%) of the tax required to be shown on the return for the taxable year, or
 - (ii) Five thousand dollars (\$5,000).

The Commission has reviewed the auditor's application of these penalties and finds both proper.

Idaho Code § 63-3045 provides for the addition of interest to any tax deficiency. Idaho Code § 63-3045(6) states in part:

- (a) Interest shall apply to deficiencies in tax and refunds of tax. Interest shall not apply to any penalty or to unpaid accrued interest. Interest relating to deficiencies or refunds accruing after the original due date of the return, but not including extensions of the due date, shall be computed on the net of any underpayments and overpayments of a tax liability required to be shown as due on the same return.
- (b) Interest upon any deficiency shall be assessed at the same time as the deficiency, shall be due and payable upon notice and demand from the state tax commission and shall be collected as a part of the tax at the rate per annum determined under the provisions of subsection (6)(c) of this section from the date prescribed for the payment of the tax. In the event any of the deficiency is reduced by reason of a carryback of a net operating loss or a capital loss

carryback, such reduction in deficiency shall not affect the computation of interest under this subsection for the period ending with the last day of the taxable year in which the net operating loss or capital loss arises.

(c) The rate of interest accruing during any calendar year, or portion thereof, upon any deficiency, or payable upon an overpayment or refund shall be two percent (2%) plus the rate determined under section 1274(d), Internal Revenue Code, by the secretary of the treasury of the United States as the midterm federal rate as it applies on October 15 of the immediately preceding calendar year rounded to the nearest whole number.

Idaho Code § 63-3045(6)

The specific wording of the Idaho Code is “interest upon any deficiency shall be assessed.” The addition of interest has been addressed in the courts. In hearing *Union Pacific R. Co. v. State Tax Com’n*, 105 Idaho 471, 670 P.2d 878 (1983), the Idaho Supreme Court addressed whether the taxpayer was required to pay interest, stating:

The general rule is that absent statutory authorization, courts have no power to remit interest imposed by statute on a tax deficiency. *American Airlines, Inc. v. City of St. Louis*, 368 S.W.2d 161 (Mo. 1963); see generally 85 C.J.S. Taxation, § 1031(c) (1954). We agree with the State that I.C. § 63-3045(c) is clear and unequivocal when it states that ‘interest ... shall be assessed’ and ‘shall be collected.’ This section is not discretionary, but rather, it is mandatory. Following the language of this section we hold that this Court, as well as the district court, lacks any power to remit the interest that is mandated by the statute.

Accordingly, the Commission finds interest is a statutory addition to tax deficiencies of which the Commission has no discretion. Therefore, the Commission will also uphold the addition of interest to Petitioner’s tax deficiency.

THEREFORE, the Notice of Deficiency Determination dated January 30, 2018, and directed to [Redacted] is hereby APPROVED and MADE FINAL.

IT IS ORDERED that Petitioner pay the following tax, penalty, and interest (computed to March 1, 2019):

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2015	\$859,943	\$128,991	\$91,794	\$1,080,728

An explanation of Petitioner's right to appeal this decision is enclosed

DATED this _____ day of _____ 2018.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2018, 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.
