

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-529-020-928
)	
Petitioner.)	DECISION
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(Petitioner) protested the Notice of Deficiency Determination dated February 25, 2021. Petitioner disagreed with the adjustments the Income Tax Audit Bureau (Bureau) made to the depreciation claimed and to the investment tax credit claimed. The Tax Commission reviewed Petitioner’s case and found Petitioner could claim the depreciation disallowed and the investment tax credit need only be adjusted for the used property limitation. Therefore, the Tax Commission modifies the Notice of Deficiency Determination.

BACKGROUND

Petitioner is a C-Corporation whose sole shareholder is _____ an S-Corporation. _____ is owned by _____, father and son. Petitioner’s business is farming, specifically potatoes. Petitioner’s 2016 - 2019 returns were selected for audit to verify the investment tax credit claimed and to review the Idaho bonus depreciation subtractions. The Bureau later expanded the audit to include depreciation claimed and the bonus depreciation additions and subtractions claimed in 2014 and 2015.

The Bureau requested specific information from Petitioner which they provided. The Bureau reviewed the information and documentation and determined the investment tax credit was overstated and some property did not qualify. The Bureau also determined Petitioner was depreciating property it did not own. The Bureau adjusted Petitioner’s returns and sent them a Notice of Deficiency Determination.

Petitioner protested stating that the ownership of the farmhouse property was indeed owned by them, and that the farmhouse was primarily used in Petitioner's trade or business. Petitioner also disagrees with the Bureau's assertion that the storage shed was for the personal use and entertainment of . Petitioner stated the shed was used to store farm equipment, feed, and supplies. Petitioner stated the shed was built on Mr. property with the understanding that all Petitioner's farmworkers would have access to the kitchen, restroom, and sauna facilities of the shed. Petitioner stated they built the shed, so they should be able to depreciate it.

Petitioner disagreed with the adjustment to their investment tax credit. Petitioner stated the fence disallowed by the Bureau was tangible personal property, not real property. Petitioner stated the disallowance of the furnishing of the farmhouse as qualified tangible personal property is incorrect because the furnishings are used in a trade or business and are not the personal property of . However, Petitioner did concede the adjustment the Bureau made regarding the purchase of qualified used property subject to the limitation.

Petitioner supplemented their argument with information and support showing that the primary use of the disallowed properties was for the business of Petitioner. Petitioner also provided support showing the chain of title for the farmhouse property was flawed in that the parties in the recorded deeds relied on by the Bureau never had the authority or the ability to transfer the farmhouse property. In addition, Petitioner argued that for federal tax purposes, ownership is determined by who incurred the cost, bore the burdens, and reaped the benefits of the property.

The Bureau reviewed Petitioner's protest, acknowledged it, and referred the matter to the Tax Commission's Appeals Unit (Appeals). Appeals sent Petitioner a letter discussing the methods available for redetermining a protested Notice of Deficiency Determination. Petitioner requested a telephone hearing. Appeals scheduled the hearing and conducted it on May 5, 2022. During the

hearing, Petitioner restated their argument concentrating on the ownership of the property both by deed and for federal tax purposes. Petitioner's argument centers on the fact that the deed to the farmhouse property was quit claimed to Petitioner in 1982 from _____ and that there has been no deed since where Petitioner transferred the property. Petitioner argued and stated that in the opinion of the County Recorder the "vesting deed" for the farmhouse is Petitioner.

Petitioner also believes an even stronger argument, according to federal tax law, the U.S. Supreme Court, and various Circuit Courts, is that the law requires the application of the economic reality test. This test requires the examination of the relative burdens and benefits of the parties with respect to the property, rather than merely the transfer of title. Petitioner relies heavily on the U.S. Supreme Court's decision in *Frank Lyon Co. vs Commissioner*, 435 US 561 (1978) in support of this position. Petitioner also cited *Bailey vs. Commissioner*, 912 F.2d 44, 47 (2CA 1990) and *AWG Leasing Trust vs. US*, 592 F. Supp. 2d 953 (2008) for the premise that courts may disregard a purported transfer where the transferor continues to retain the benefits and burdens of ownership, or where the "owner" failed to show they enjoyed the benefits or carried the burdens of ownership.

In relation to the depreciation claimed on the shed, Petitioner did not argue that they owned the property the shed was built on. Petitioner acknowledged the fact that the property is owned by _____ (Trust). Nevertheless, Petitioner argued because the shed was built for their benefit, with their capital, and the burden of ownership is theirs, for tax purposes they are entitled to depreciate the shed. Appeals asked if there was a rental or lease agreement between Petitioner and Trust. Petitioner stated it was a verbal agreement that Trust allowed the shed to be built as long as Petitioner allowed all Petitioner's farm workers to use the facilities included with the shed. Petitioner stated all farm buildings Petitioner built or remodeled

were approved by Petitioner's Board even though it may not be memorialized in minutes of the Board.

As for the investment tax credit claimed on the furnishings for the farmhouse, Petitioner used much the same argument. Petitioner stated they have the burden of ownership, and the farmhouse is provided for the onsite manager as a requirement for employment. Petitioner stated the furnishings are business expenses and not the personal property of

In response to the investment tax credit on the disallowed fencing, Petitioner stated the fencing was used to keep cattle confined to their place. Petitioner stated during a downturn in the potato market, they branched out and tried raising cattle. Petitioner stated the fencing was acquired to corral the cattle. Petitioner stated raising cattle did not prove to be profitable, so it was not continued. Nevertheless, Petitioner stated the fencing is removable and therefore tangible personal property eligible for the investment tax credit.

LAW AND ANALYSIS

Internal Revenue Code (IRC) section 162 provides for the deduction of all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. IRC section 167 allows depreciation as a deduction for a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business.

Petitioner claimed depreciation on a farmhouse that they use in their business of farming. Petitioner stated the farmhouse is provided to the farm manager as a condition of employment. Petitioner stated the farm manager is required to be on the farm premises 24/7, with few exceptions, to oversee the farm workers, for the security of the farm equipment, buildings, irrigation equipment, and aeration and fumigation equipment, and protecting the value of growing and stored

crops. Petitioner stated the farmhouse was remodeled in 2014 after the prior farm manager,

decided to retire. Petitioner took out a loan for the remodel and made all the payments on the loan. Petitioner furnished the farmhouse for the current farm manager, The farmhouse, the remodel, and furnishings are all listed as depreciable assets on Petitioner's books.

The Bureau contends that Petitioner is not entitled to depreciate the farmhouse because it is not the owner of the property. The Bureau found in its research of the property that there were several recorded deeds with the county. The Bureau determined in its review of the deeds that the farmhouse property was transferred out of Petitioner in 2006 and later acquired by

in 2015. The Bureau stated that since Petitioner did not own the property, it could not depreciate it and therefore disallowed the depreciation from 2014 through 2019. The Bureau also made corresponding adjustments to the bonus depreciation reported on Petitioner's returns because of the disallowed depreciation.

The Tax Commission reviewed the information presented and found that the farmhouse property was transferred to Petitioner by a Quit Claim Deed in 1982. Since then, the county recorded various other deeds and documents including the two relied upon by the Bureau. The Bureau conversed with the county recorder and relying on that information, determined the farmhouse property was owned by , the current farm manager. However, the county recorder did acknowledge and recognize that there was a gap or missing documentation in the chain of title. The gap being the transfer of the property by Quit Claim Deed from Petitioner to any of the parties eventually ending with . Therefore, from a legal perspective Petitioner still owns the farmhouse property.

Petitioner argues further that regardless of title ownership, for tax purposes they are considered the owner and are entitled to the depreciation deductions because all the benefits and

burdens of ownership are theirs. Petitioner referenced Treasury Regulation § 1.263A-2 relating to the capitalization rules for property produced by a taxpayer for use in its trade or business, noting that a taxpayer may be considered an owner of property produced even though the taxpayer does not have legal title to the property. Petitioner also cited Treasury Regulation § 1.263(a)-3 referencing improvements made to tangible property in the definition of real property meaning land and the improvement to it such as buildings, and the definition of owner as the taxpayer that has the benefits and burdens of ownership of the unit of property for federal income tax purposes. In further support of the benefits and burdens argument, Petitioner cited decisions of the Supreme Court (*Frank Lyon Co. vs. Comm.*, supra and *AWG Leasing Trust vs. US*, supra), the Court of Appeals (*Bailey vs. Comm.*, supra), and the Tax Court (*Grodts & McKay Realty, Inc. v. Comm.*, 77 TC 1221 (1981)). In each case, the court held that even if title was actually held, if the taxpayer did not acquire sufficient burdens and benefits of ownership to meet the economic analysis test, a transfer of tax ownership did not occur.

In the case at hand, Petitioner's capital was used to remodel the farmhouse. Petitioner took out the loan and service the debt for the remodel. Petitioner has consistently used the farmhouse property in their business since acquiring it in 1982, thus reaping the benefits of any income related to the property. Petitioner has paid all the expenses and utilities related to the property. Petitioner has shown the property on their books as an asset for forty years. No one other than Petitioner has had the burdens or enjoyed the benefits of owning the farmhouse property.

Considering the tax law, judicial precedent, and legal title, the Tax Commission finds that Petitioner is the true tax owner of the farmhouse property. Furthermore, the Tax Commission finds the farmhouse was used in Petitioner's farming activities and the farm manager was required to

live in the farmhouse as a condition of employment. Therefore, Petitioner can depreciate the farmhouse, the farmhouse improvements, and the farmhouse furnishings.

Petitioner also claimed depreciation on a shed built on property owned by Trust. Petitioner argued the same burdens and benefits of ownership and economic analysis test argument to support their claim to depreciation. The Bureau on the other hand disallowed the depreciation stating that Petitioner does not own the property the shed is built on, and the shed is used for personal entertainment and personal storage, not the storage of farm equipment.

Petitioner built the shed on property owned by Trust. Petitioner stated Trust allowed Petitioner to build the shed to store expensive farm equipment, feed, and supplies. Petitioner built the shed with kitchen facilities, a restroom, and a dry sauna. Petitioner stated that as a condition of building the shed on Trust's property, Petitioner must have the kitchen, restroom, and sauna available to all Petitioner's employees. Petitioner provided an affidavit signed by Petitioner's employees acknowledging that they had access to the shed's facilities. When asked if there was a lease agreement between Trust and Petitioner, Petitioner stated the agreement was an oral agreement and no rent is paid to Trust.

As previously stated, IRC section 162(a) allows as a current deduction from gross income all the ordinary and necessary expenses incurred in carrying on a trade or business. IRC section 263(a)(1) disallows the current deduction of capital expenditures that would otherwise have been currently deductible trade or business expenses. Therefore, a taxpayer's deductions for capital expenditures usually come by way of amortization or depreciation. *See* IRC sections 167, 168, and 169. Capital expenditures are, with limited exceptions, any amounts paid for new buildings, permanent improvements, and restoration.

A taxpayer's entitlement to depreciation deductions for leasehold improvements hinges not on legal title but on a recognized investment in the property. *Hopkins Partners v. C.I.R.*, T.C. Memo 2009-107 (2009). The important question is whether the taxpayer made an investment of capital that the taxpayer is entitled to recover. *Hopkins Partners*, supra. The one who made the investment is entitled to its return. *Gladding Dry Goods Co. v. Commissioner*, 2 B.T.A. 336, 338 (1925). The material elements are the person who makes the investment, use of the property, and the period over which that investment is to be recovered out of income. *Gladding Dry Goods Co.*, supra. In this case, Petitioner made the investment (put up the capital to build the shed), Petitioner uses the shed for storage and for the benefit of their workers, and Petitioner has continued use of the shed as long as they are in good standing with Trust. Therefore, based on statute and case law, the Tax Commission finds Petitioner is entitled to the depreciation of their invested capital in the shed.

The Bureau adjusted Petitioner's claim of investment tax credit for furnishings purchased for the farmhouse and for fencing. The Bureau stated the farmhouse furnishings were personal expenses rather than business expenses, and the fencing is a real property improvement attached to real property.

As discussed earlier, the Tax Commission decided the farmhouse is an asset of Petitioner's that was provided for the farm manager as a requirement of the position. Likewise, the farmhouse furnishings are business expenses of Petitioner, depreciable by Petitioner, as a fringe benefit for the requirement that the farm manager live in the farmhouse and be available 24/7. Therefore, the farmhouse furnishings are business expenses and are qualifying tangible personal property for the investment tax credit.

As for the fencing, Petitioner stated the fence was for their cattle raising venture. Petitioner stated they tried to diversify their operation during a downturn in the potato market. Petitioner stated they decided to try raising cattle. Petitioner acquired additional space for the cattle and fenced it to keep the cattle confined. Petitioner stated the fencing is removable, not permanently attached to the ground. Petitioner stated because the fencing is not a permanent fixture, it is not an improvement to real property and qualifies as tangible personal property for the investment tax credit.

Idaho Code section 63-3029B provides for the Idaho investment tax credit and defines the property that qualifies for the credit. Subsection (3) states that a qualified investment means certain property as defined in IRC sections 46(c) and 48 of the Internal Revenue Code of 1986 prior to November 5, 1990. IRC section 48 defines section 38 property which section 46(c) identifies as a qualified investment. Treasury Regulation § 1.48-1 provides clarification as to what qualifies as section 38 property. Included in Treasury Regulation § 1.48-1(d) is other property that is an integral part of manufacturing, production, or extraction. Specifically identified in subsection (d)(4) is “fencing used to confine livestock.” The Regulation considers fencing used for that purpose as an integral part of the production of raising livestock. Therefore, since the Regulations carved out fencing used to confine livestock as qualified investment property, it makes no difference if the fencing is a permanent fixture or removable. The Tax Commission allows the investment tax credit for the fencing.

The Bureau made an adjustment to Petitioner’s investment tax credit claimed on used property. IRC section 48(c)(2) limits the amount of used property that can be claimed as qualified investment property. The limitation is \$150,000 of the cost of used section 38 property placed in service during the taxable year. Petitioner did not contest this adjustment in their protest which

was also confirmed by Appeals during the hearing. Therefore, the Tax Commission upholds the adjustment for the investment tax credit on used qualifying investment property.

CONCLUSION

Petitioner claimed depreciation deductions on property the Bureau did not believe Petitioner had a vested interest to claim. However, based on the information available, the statutes, and established case law, the Tax Commission found Petitioner had an interest either by actual ownership, tax ownership, or the investment of their capital. Therefore, the Tax Commission allows the depreciation deductions claimed. The Tax Commission also allows the additions and subtractions Petitioner claimed as bonus depreciation allowances.

Petitioner claimed Idaho investment tax credit on property the Bureau asserted was not qualified investment property. Upon review, the Tax Commission found the property was qualified investment property and the only applicable adjustment to Petitioner's investment tax credit is to the used investment property acquired in 2019 because the used property limitation was exceeded.

The Bureau added interest and penalty to Petitioner's Idaho tax deficiency. The Tax Commission reviewed those additions and found the interest addition appropriate and in accordance with Idaho Code section 63-3045. However, seeing that the only remaining adjustment was an oversight by Petitioner's tax preparer of a federal law that was repealed and eliminated from the IRC over 30 years ago, the Tax Commission finds the negligence penalty inappropriate.

THEREFORE, the Notice of Deficiency Determination dated February 25, 2021, and directed to _____ is AFFIRMED as MODIFIED by this decision.

IT IS ORDERED that Petitioner pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2014	\$0	\$0	\$0
2015	0	0	0
2016	0	0	0
2017	0	0	0
2018	0	0	0
2019	3,123	215	\$3,338

Interest is calculated to December 15, 2022.

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

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

DATED this _____ day of _____ 2022.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2022,
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:

Receipt No.
