

12-2803
TAX TYPE: INCOME TAX
TAX YEAR: 2010
DATE SIGNED: 3-17-2014
COMMISSIONERS: B. JOHNSON, D. DIXON, M. CRAGUN, R. PERO
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER,

Petitioner,

vs.

AUDITING DIVISION OF THE
UTAH STATE TAX COMMISSION,

Respondent.

INITIAL HEARING ORDER

Appeal No. 12-2803

Account No. #####

Tax Type: Income Tax

Tax Year: 2010

Judge: Phan

Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: TAXPAYER

For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney
General
RESPONDENT, Manager, Income Tax Auditing

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on January 6, 2014 for an Initial Hearing in accordance with Utah Code §59-1-502.5. Petitioner (“Taxpayer”) is appealing an audit deficiency issued against him for the 2010 tax year. The Notice of Deficiency and Audit Change had been issued on October 16, 2012. The amount of the audit deficiency had been \$\$\$\$ in tax and \$\$\$\$ in interest. Interest continues to accrue until paid in full. No penalties were assessed with the audit. The reason for the audit deficiency was that Respondent (“Division”) had disallowed a credit for capital gains expended to purchase stock in a Utah small business under Utah Code §59-10-1022.

APPLICABLE LAW

A credit is provided when capital gains are expended to purchase qualifying stock in a Utah small business with specified limitations pursuant to Utah Code 59-10-1022(2010)¹ as follows:

(2) For taxable years beginning on or after January 1, 2008, a claimant, estate, or trust that meets the requirements of Subsection (3) may claim a nonrefundable tax credit equal to the product of: (a) the total amount of the claimant's, estates, or trust's short term capital gain or long-term capital gain on a capital gain transaction that occurs on or after January 1, 2008; and (b) 5%.

(3) For purposes of Subsection (2), a claimant, estate, or trust may claim the nonrefundable tax credit allowed by Subsection (2) if: (a) 70% or more of the gross proceeds of the capital gain transaction are expended: (i) to purchase qualifying stock in a Utah small business corporation; and (ii) within a 12-month period after the day on which the capital gain transaction occurs; and (b) prior to the purchase of the qualifying stock described in Subsection (3)(a)(i), the claimant, estate, or trust did not have an ownership interest in the Utah small business corporation that issued the qualifying stock.

...

(5) In accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, the commission may make rules: (a) defining the term "gross proceeds"; and (b) Prescribing the circumstances under which a claimant, estate, or trust has an ownership interest in a Utah small business corporation.²

The Commission has been granted the discretion to waive penalties and interest. Utah Code Ann. §59-1-401(13) provides, "Upon making a record of its actions, and upon reasonable cause shown, the commission may waive, reduce, or compromise any of the penalties or interest imposed under this part."

Utah Code Ann. §59-1-1417 provides, "[i]n a proceeding before the commission, the burden of proof is on the petitioner..."

The Commission has promulgated Administrative Rule R861-1A-42 to provide additional guidance on the waiver of interest, as follows in pertinent part:

(2) Reasonable Cause for Waiver of Interest. Grounds for waiving interest are more stringent than for penalty. To be granted a waiver of interest, the taxpayer must prove that the commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error.

¹ The decision cites to the 2010 provisions.

² Although the Tax Commission has been given authority to adopt a rule prescribing when a taxpayer has an ownership interest in a Utah small business corporation, no rule was cited by the parties and it appears none was adopted.

DISCUSSION

As far as the Division was aware, the issue in this hearing was a matter of first impression before the State Tax Commission in an appeal.³ Utah Code 59-10-1022 provides for a nonrefundable tax credit if 70% or more of the gross proceeds of a capital gain are expended to purchase qualifying stock in a Utah small business corporation and prior to the purchase of the qualifying stock the taxpayer did not have an ownership interest in the Utah small business. The question in this appeal was whether or not the Taxpayer had an ownership interest in the Utah small business corporation when he expended the proceeds from a capital gain to purchase stock in the corporation.

The Taxpayer had entered into a Subscription Agreement on June 22, 2010 to purchase ##### shares of common stock from CORPORATION. (“Corporation”) for a price of \$\$\$\$\$. There was no dispute that this was a Utah small business corporation. The agreement provided however, that the payment would be made in three installments. The first installment was to be \$\$\$\$\$ by July 15, 2010, the second was to be \$\$\$\$\$ by December 15, 2010 and the final installment \$\$\$\$\$ by May 15, 2011. It was the Taxpayer’s argument that he did not own any stock or any interest in the Corporation until payment was made in full.

The Taxpayer had made the first installment to acquire Corporation stock based on the Subscription Agreement in July 2010. His capital gain transaction occurred when he received \$\$\$\$\$ in total capital gains on December 6, 2010 and December 9, 2010 from the sale of share of BUSINESS. This is the amount of the credit he claimed on Line 23 of his Utah TC-40 return. The Division has disallowed the full amount of the credit. However, it should be noted that if the credit would be allowed under Utah Code 59-10-1022, it is limited to 5% of the qualifying capital gains, not the entire amount of the gain as claimed by the Taxpayer on his return.

The Taxpayer states that he then expended the \$\$\$\$\$ in capital gains received from the BUSINESS shares towards the installment payments in the Subscription Agreement to acquire stock in Corporation. The Division argued that the Taxpayer had an ownership interest or at least an ‘equitable’ ownership interest in the Corporation before he expended the capital gain because he had signed the Subscription Agreement in June 2010, made the first payment in July 2010 and did not receive the capital gains until December 2010. The Subscription Agreement was provided and it stated in pertinent part:

Based upon the terms and representations of this Agreement given by each party to the other, the Subscriber hereby irrevocably subscribes for and agrees to

³ The Commission has previously issued Private Letter Ruling, PLR 13-004, December 13, 2013, dealing with several issues on the Utah Capital Gains Credit provided at Utah Code. Sec. 59-10-1022, but did not address the circumstances under which a taxpayer would be considered to have an ownership interest.

purchase ##### common Stock of the Company, at a per share subscription price of \$\$\$\$ USD, for the aggregate consideration of \$\$\$\$ USD (the “Subscription Price”).

The Taxpayer stated that he never received stock certificates in return for making the payments and argues that he did not purchase \$\$\$\$ worth of shares with the first installment and then more shares with the second installment, instead that he did not own any of the shares until all the payments were made. The Taxpayer stated that he did not have an ownership interest in the Corporation prior to entering into the Subscription Agreement.

Neither side provided any case law or prior Tax Commission decisions as guidance in this matter. The Division stated this was a matter of first impression before the Tax Commission, so that there had been no prior appeals. Furthermore, no rule has been adopted by the Tax Commission to prescribe the circumstances when a claimant is considered to have an ownership interest, which had been provided for at Utah Code Sec. 59-10-1022(5). This Taxpayer did not have an ownership interest in Corporation until he entered into the Subscription Agreement and the agreement itself is unclear whether the stock ownership transferred piecemeal based on the installment payments or in one lump sum when all payments were made. The Division argues there was at least an equitable ownership interest in July 2010 when the Taxpayer had made the first installment payment of \$\$\$\$\$. This was prior to the Taxpayer receiving the capital gain and the Taxpayer could not have expended the capital gain until after it was received.

In order to receive the credit, Utah Code Sec. 59-1-1022 contemplates two different transactions and both transactions have a number of stated requirements under the statute that need to be met. First there must be qualifying capital gains transaction. The second transaction is that the proceeds from the capital gain transaction are expended to purchase qualifying stock in a Utah small business corporation. Among other requirements for the second transaction, the taxpayer must not have a prior ownership interest in the small business corporation. In Private Letter Ruling PLR 13-004, the Commission had considered the effect of an installment payment agreement for the first transaction, the capital gains transaction. The question in that ruling concerned a “capital gain” received by a taxpayer based on an installment agreement. The Commission answered the question stating in part, “The Commission interprets “capital gain transaction” as occurring only once for an installment sale, when the parties enter into the installment sale contract.”

In this appeal currently before the Commission, the question involves the second transaction; expending the proceeds from the capital gain to purchase stock in a Utah small business corporation. PLR 13-004 is not controlling, but may be considered for guidance. As the

Commission has yet to adopt a rule prescribing the circumstances under which a taxpayer has an ownership interest in the small business corporation, the Commission may apply the same conclusion on installment contracts for the capital gain transaction to the second transaction of expending the proceeds to purchase qualifying stock. If the purchase of the qualifying stock occurs only once for the installment purchase and that is when the Taxpayer entered into the Subscription Agreement on June 22, 2010, the Taxpayer had an ownership interest in the stock of Corporation on June 22, 2010. The capital gain transaction did not occur until later, in December 2010. The Taxpayer's purchase of the stock in Corporation would fail to meet the requirement at Utah Code Sec. 59-10-1022(3)(b), because he had an ownership interest in Corporation before he expended his capital gain to purchase the stock in Corporation. The audit deficiency should be upheld.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Taxpayer's appeal is denied. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2014.

R. Bruce Johnson
Commission Chair

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Appeal No. 12-2803

Notice of Payment Requirement: Any balance due as a result of this order must be paid within thirty (30) days of the date of this order, or a late payment penalty could be applied.