13-1621
TAX TYPE: INCOME TAX
TAX YEARS: 2008 & 2010
DATE SIGNED: 1-29-2015
COMMISSIONERS: J. VALENTINE, M. CRAGUN, R. PERO
EXCUSED: D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER-1 & TAXPAYER-2, Petitioners, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 13-1621 Account No. ##### Tax Type: Income Tax Years: 2008 & 2010 Judge: Chapman

Presiding:
Kerry R. Chapman, Administrative Law Judge

Appearances:
For Petitioner: TAXPAYER-1, Taxpayer
For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General
RESPONDENT, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on September 9, 2014.

TAXPAYER-1 and TAXPAYER-2 ("Petitioners" or "taxpayers") are appealing Auditing Division's (the "Division") assessment of additional individual income tax for the 2008 and 2010 tax years. On December 13, 2011, the Division issued two Notices of Deficiency and Audit Change to the taxpayers, one for the 2008 tax year and the other for the 2010 tax year ("Statutory Notices"). In the Statutory Notices, the Division imposed additional tax and interest (calculated as of January 12, 2012),[1] as follows:

1 Interest continues to accrue until any tax liability is paid.

Year	Tax	Penalties	Interest	Total
2008	$$$$$	$$$$$	$$$$$	$$$$$
2010	$$$$$	$$$$$	$$$$$	$$$$$

The Division made the assessments after determining that the taxpayers did not qualify for nonrefundable tax credits they claimed in the amounts of $$$$$ for 2008 and $$$$$ for 2010.[2] The taxpayers claimed the credits under Utah Code Ann. §59-10-1022, which allows a "capital gain credit" associated with certain purchases of qualifying stock in a Utah small business corporation. The taxpayers ask the Commission to find that they are entitled to the capital gain credits and to reverse the Division's assessments. The Division asks the Commission to find that the taxpayers are not entitled to the capital gain credits and to sustain its assessments.

The Division argues that under Section 59-10-1022, a taxpayer must meet a number of requirements to qualify for the capital gain credit. The Division claims that a taxpayer must reinvest 70% or more of the gross proceeds from a capital gain transaction, reinvest these proceeds in qualifying stock of a Utah small business corporation, reinvest these proceeds within 12 months of the capital gain transaction, and not have a prior ownership interest in the Utah small business corporation.

The Division argues that the taxpayers did not meet these requirements because they never reinvested the gross proceeds they received from their capital gain transaction that occurred in 2008. The Division argues that instead of investing these proceeds, TAXPAYER-1 granted an intellectual property license to a company he already owned in exchange for stock in 2010, more than 12 months after the capital gain transaction occurred. As a result, the Division claims that the taxpayers are not entitled to a capital gain credit. The

2 For 2008, the taxpayers reported that their Utah income tax liability was $$$$$. Because the 2008 credit of $$$$$ that the taxpayers claimed was nonrefundable, the taxpayers used this credit to reduce their 2008 tax liability by $$$$$ to $$$$$. For 2010, the taxpayers reported that their liability was greater than the 2010 credit of $$$$$ that they claimed. As a result, they used this credit to reduce their 2010 tax liability by the full amount of this credit

Division also points out that Utah statutes providing for credits are to be narrowly construed against the party claiming the credit. The Division contends that Section 59-10-1022 should not be construed as broadly as the taxpayers request and asks the Commission to sustain its assessments.

The taxpayers contend that within months of the capital gain transaction at issue, they invested $$$$$ in cash and $$$$$ in intellectual property in exchange for qualifying stock in a Utah small business corporation pursuant to a November 2008 "written informal agreement" and/or oral agreement. They contend that this investment should be sufficient to qualify for the capital gain credits they claimed. The taxpayers acknowledge that the intellectual property they invested was not itself some type of capital gain. But, they argue that cash is also not some type of capital gain. They contend that cash and property are both forms of wealth and that a capital gain is an increase in wealth. As a result, they contend as long as they invest assets, including property, that have a value equal to 70% or more of the gross proceeds of the capital gain transaction, they should be able to qualify for the capital gain credit. The taxpayers contend that the Commission should allow some latitude and reach this conclusion. Otherwise, they argue that it will defeat the capital gain credit's purpose to promote the formation of Utah start-up corporations, which benefits the state and its residents.

In addition, the taxpayers claim that they invested the intellectual property and the $$$$$ in cash within 12 months of the capital gain transaction occurring on June 30, 2008. They admit that TAXPAYER-1 did not sign the closing documents to "formalize" the November 2008 written informal agreement and/or oral agreement until 2010, which is not within the 12-month period after the June 30, 2008 date of the capital gain transaction. Nevertheless, they contend that the informal November 2008 agreement(s) should satisfy the 12-month requirement.

Furthermore, the taxpayers assert that they did not have an ownership interest in the Utah small business corporation prior to their purchase of its stock in November 2008. As evidence, they provided an April 30, 2011 letter from the Utah small business corporation attesting to this assertion. This letter was signed

by TAXPAYER-1 (the taxpayer) as President of the corporation. For these reasons, the taxpayers contend that they qualify for the capital gain credits they claimed and ask the Commission to reverse the Division's assessments.

FACTS

1. Sale of BUSINESS-1 Stock. TAXPAYER-1 was a founder and employee of BUSINESS-1 ("BUSINESS-1") until he resigned his employment in 2007. After the resignation, TAXPAYER-1 and BUSINESS-1 disputed ownership of a provisional US Patent application entitled "Cross- System Proxy system". In anticipation of BUSINESS-1'S immediate merger with BUSINESS-2 in mid-2008, TAXPAYER-1 and BUSINESS-1 resolved their patent dispute.

2. On June 28, 2008, TAXPAYER-1 and BUSINESS-1 entered into an Intellectual Property License Agreement ("BUSINESS-1 Agreement"), in which TAXPAYER-1, as owner of the Cross- System Proxy system, granted BUSINESS-1 a nonexclusive license to the property. In return, BUSINESS-1 agreed to pay TAXPAYER-1 a "front-end" payment of $$$$$ (the total payment in 2008 for the license would end up being in excess of $$$$$). In addition, the BUSINESS-1 Agreement provided that TAXPAYER-1 would liquidate his stock in BUSINESS-1 as part of the BUSINESS-2 merger agreement. BUSINESS-1 agreed to pay TAXPAYER-1 for the stock at the same "time or times" other stockholders would be paid under the merger agreement with BUSINESS-2.

3. On June 30, 2008, BUSINESS-1 closed its merger with BUSINESS-2. The "Merger Agreement" between BUSINESS-1 and BUSINESS-2 provided the price that would be paid for BUSINESS1'S stock and provided that the payment would be made in two installments. While most of the payment amount was to be paid "at closing," a portion was deferred and retained to satisfy valid indemnification claims. The Merger Agreement also provided that any portion of the deferred payment amount not subject to valid indemnification claims would be paid "after the 18-month anniversary of the Merger."

4. For the 2008 tax year, BUSINESS-1 issued two tax documents to TAXPAYER-1: 1) a Form 1099-B (Proceeds from Broker and Barter Exchange Transaction), reporting $$$$$ of "gross proceeds" from the August 13, 2008 sale or exchange of "stocks, bonds, etc." (i.e., the first installment payment for the BUSINESS-1 stock); and 2) a Form 1099-MISC, reporting $$$$$ of nonemployee compensation.

5. On Schedule D (Capital Gains and Losses) of the taxpayers' 2008 federal return, they reported a long-term capital gain of $$$$$ from the sale of BUSINESS-1 stock (based on the sales price of $$$$$ minus a cost or other basis of $$$$$).[3]

6. On the taxpayers' 2008 Utah return, they claimed a capital gain credit of $$$$$ (which is 5% of the 2008 capital gain of $$$$$ associated with the sale of the BUSINESS-1 stock).

7. For the 2010 tax year, BUSINESS-1 issued one tax document to TAXPAYER-1, a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions), reporting $$$$$ of "gross proceeds" from the April 30, 2010 sale or exchange of "stocks, bonds, etc." (i.e., the second installment payment for the BUSINESS-1 stock).

8. On Schedule D (Capital Gains and Losses) of the taxpayers' 2010 federal return, they reported a long-term capital gain of $$$$$ from the sale of BUSINESS-1 stock (based on the sales price of $$$$$ minus a cost or other basis of $$$$$).

9. On the taxpayers' 2010 Utah return, they claimed a capital gain credit of $$$$$ (which is 5% of the 2010 capital gain of $$$$$ associated with the sale of the BUSINESS-1 stock).

10. Investment in CORPORATION. In 2008, a new "venture" began that would subsequently be known as CORPORATION ("CORPORATION"). From the evidence proffered at the Initial hearing, the venture was first referred to in an email dated August 9, 2008. The email was written by NAME-1 to WEB ADDRESS and was copied to TAXPAYER-1. In this email, NAME-1 stated the following (in pertinent part):

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3 The $$$$$ of nonemployee compensation was not reported on Schedule D. TAXPAYER-1 stated that this income is ordinary income, not capital gains. TAXPAYER-1 also stated that this is the total amount that

> I am writing the software implementation for the "CROSS-SYSTEM PROXY-BASED TASK OFFLOAD MECHANISM" (patent applied for), a concept designed by TAXPAYER-1. Basically this mechanism will direct workload from a z/OS system over to a non BUSINESS-2 platform, aka the Offload System. . . . For our proof of concept for the investors we have chosen to offload DFSORT jobs off of z/OS over to a Linux BUSINESS-1 and of course your product works hand in glove with our Proxy Sort Server. . . .
>
> At present, TAXPAYER-1 has not formed a company as such funding is still being sought, however would BUSINESS-3, be willing for us to work together on our DFSORT Proxy solution. . . .

11. The Utah Department of Commerce website indicates that "CORPORATION S" (without any identified "company type") was registered on October 11, 2008 and has an "expired" status as of February 11, 2009. In addition, it shows that "CORPORATION" (with a "company type" of "Corporation – Domestic – Profit) was registered on February 6, 2009 and has an "active" status.[4] Both of these registrations show the business's address to be ADDRESS, CITY, Utah ZIP CODE, which is the home address of the taxpayers.

12. On November 1, 2008, TAXPAYER-1 (the taxpayer) sent an email to his brother, NAME-2, concerning their discussion about NAME-2 becoming the Acting CFO of CORPORATION. In the email, TAXPAYER-1 (the taxpayer) stated the following (in pertinent part):

> It was good to chat with you this evening about my new venture, CORPORATION (CORPORATION). Here is a one-pager about the technology and another one-pager outlining a proposed equity and compensation structure, including the approximate terms (negotiable) that were discussed for you as Acting CFO. . . .

A "one-pager" referred to in the email that outlines the proposed equity and compensation structure specifically identifies TAXPAYER-1 as Acting Chairman, President & CEO; NAME-2 as Acting Treasurer & CFO; NAME-1 as Acting Chief Engineer; and NAME-3 as Advisor. It also outlines the following equity and compensation structure for these persons, as follows in pertinent part:

> <u>Series A Preferred</u>
> - $$$$$/share
> - #X liquidation preference
> - Participating

BUSINESS-1 paid in 2008 to receive a nonexclusive license of the Cross-System Proxy system.

4 This information can be viewed by typing in the name "CORPORATION" at WEB ADDRESS.

TAXPAYER-1, Acting Chairman, President & CEO

- $$$$$ shares for paid-up patent license, included related consulting up to a max of ##### hrs within ##### yrs ($$$$$/hr thereafter if needed)
- $$$$$ deferred payment for patent license/consulting
- $$$$$ seed cash investment

. . . .

Common Stock Option Pool and/or Restricted Founders Stock

- $$$$$ shares pre-money (about 20% fully diluted)
- Post-money percentage to be determined in conjunction with investors, with the goal to be "made whole" (i.e., stay at 20%).
- $$$$$/share exercise price
- ##### year vesting, accelerated uon liquidation event

CEO 8%

. . . .

TAXPAYER-1

- $$$$$ shares pre-money
- Up to %% post-money

. . . .

13. CORPORATION and NAME-2 entered into a Consulting Services Agreement dated November 1, 2008, in which NAME-2 agreed to provide CORPORATION "consultation services and assistance to [CORPORATION] as acting Treasurer and CFO." In return, NAME-2would be paid for his services with CORPORATION convertible stock, CORPORATION restricted common stock or stock options, and deferred cash. TAXPAYER-1 (the taxpayer) signed the agreement on behalf of CORPORATION and identified himself as CORPORATION'S President.[5] The agreement listed CORPORATION'S address as ADDRESS, CITY, Utah ZIP CODE, which is the taxpayers' home address.

14. CORPORATION and NAME-1 entered into a Consulting Services Agreement dated December 18, 2008, in which NAME-1 agreed to provide CORPORATION "consultation services and technical assistance to CORPORATION related to the development and testing of proxy coupling technology." In return, NAME-1 would also be paid for his services with CORPORATION convertible stock,

5 To avoid confusion, NAME-2 will be referred to hereafter as the "CFO." Any use of the term "TAXPAYER-1" refers to TAXPAYER-1, the taxpayer.

CORPORATION restricted common stock or stock options, and deferred cash. TAXPAYER-1 signed the agreement on behalf of CORPORATION and identified himself as CORPORATION'S President. This agreement also listed CORPORATION'S address as the taxpayers' home address.

15. On December 19, 2008, NAME-1 sent an email to TAXPAYER-1, in which he stated: "Thanks for the contract, attached is my signed copy" and "Looking forward to the new venture."

16. On March 24, 2009, TAXPAYER-1 stated in an email to the CFO that he still planned "to invest $$$$$ to give us a little working capital. One of our first expenses will probably be to engage a securities attorney to help us properly issue our company stock/options."

17. On April 11, 2009, TAXPAYER-1 wrote a personal check to CORPORATION in the amount of $$$$$. The memo section of the check states that it is for "##### shares."

18. On April 2, 2010, CORPORATION and TAXPAYER-1 entered into an Intellectual Property License Agreement. In this agreement, TAXPAYER-1 conveyed to CORPORATION a license in the Cross-System Proxy system . In return, CORPORATION agreed that "[p]romptly after signing of this Agreement, [CORPORATION] shall issue ##### shares of [CORPORATION] Convertible Common Stock" to the taxpayers, as trustees of the TAXPAYER'S Family Trust. The CFO signed the agreement on behalf of CORPORATION. The agreement contains no representation that it is a ratification of prior actions or transactions of either TAXPAYER-1 or CORPORATION, but states that "[t]his Agreement represents the entire agreement between the parties. . . ."

19. On May 3, 2010, TAXPAYER-1 and CORPORATION entered into a Stock Purchase Agreement. In the agreement, CORPORATION sold TAXPAYER-1 ##### shares of CORPORATION convertible common stock at a price of $$$$$ per share. In return, TAXPAYER-1 agreed to pay $$$$$ cash and to transfer and assign his rights to the business plan of CORPORATION and any intellectual property related to CORPORATION'S business. The CFO signed the agreement on behalf of CORPORATION. The

agreement contains no representation that it is a ratification of prior actions or transactions of either TAXPAYER-1 or CORPORATION or that it represents the entire agreement between the parties. TAXPAYER-1 contends that this Stock Purchase Agreement is the "final" agreement that puts into place the prior, informal agreement(s) from late 2008, when he claims to have sold a license of the Cross- System Proxy system to CORPORATION to start the company.

APPLICABLE LAW

UCA §59-10-1022 (2008)[6] provides a nonrefundable tax credit concerning certain purchases of qualifying stock in a Utah small business corporation, as follows in pertinent part:

> (1) As used in this section:
> (a) (i) "Capital gain transaction" means a transaction that results in a:
> (A) short-term capital gain; or
> (B) long-term capital gain.
> (ii) In accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, the commission may by rule define the term "transaction."
> (b) "Commercial domicile" means the principal place from which the trade or business of a Utah small business corporation is directed or managed.
> (c) "Long-term capital gain" is as defined in Section 1222, Internal Revenue Code.
> (d) "Qualifying stock" means stock that is:
> (i) (A) common; or
> (B) preferred;
> (ii) as defined by the commission by rule made in accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, originally issued to:
> (A) a claimant, estate, or trust; or
> (B) a partnership if the claimant, estate, or trust that claims a tax credit under this section:
> (I) was a partner on the day on which the stock was issued; and
> (II) remains a partner until the last day of the taxable year for which the claimant, estate, or trust claims a tax credit under this section; and
> (iii) issued:
> (A) by a Utah small business corporation;
> (B) on or after January 1, 2008; and
> (C) for:
> (I) money; or
> (II) other property, except for stock or securities.
> (e) "Short-term capital gain" is as defined in Section 1222, Internal Revenue Code.
> (f) (i) "Utah small business corporation" means a corporation that:

6 The Utah law providing for a capital gain credit was the same in both 2008 and 2010.

(A) except as provided in Subsection (1)(f)(ii), is a small business corporation as defined in Section 1244(c)(3), Internal Revenue Code;
(B) except as provided in Subsection (1)(f)(iii), meets the requirements of Section 1244(c)(1)(C), Internal Revenue Code; and
(C) has its commercial domicile in this state.
(ii) The dollar amount listed in Section 1244(c)(3)(A) is considered to be $2,500,000.
(iii) The phrase "the date the loss on such stock was sustained" in Sections 1244(c)(1)(C) and 1244(c)(2), Internal Revenue Code, is considered to be "the last day of the taxable year for which the claimant, estate, or trust claims a tax credit under this section."
(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, estate's, 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.[7]

UCA §59-1-1417 (2014) provides that the burden of proof is upon the petitioner in proceedings before the Commission, with limited exceptions as follows:

(1) In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:
(a) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
(b) whether the petitioner is obligated as the transferee of property of the person that originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and

7 Although the Tax Commission has been given authority to adopt a rule defining the term "gross proceeds" and prescribing when a taxpayer has an ownership interest in a Utah small business corporation, no rule was cited by the parties. The Division stated that the Tax Commission has not adopted any rule addressing the capital gain credit.

> (c) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income:
>
> (i) required to be reported; and
>
> (ii) of which the commission has no notice at the time the commission mails the notice of deficiency.
>
> (2) Regardless of whether a taxpayer has paid or remitted a tax, fee, or charge, the commission or a court considering a case involving the tax, fee, or charge shall:
>
> (a) construe a statute imposing the tax, fee, or charge strictly in favor of the taxpayer; and
>
> (b) construe a statute providing an exemption from or credit against the tax, fee, or charge strictly against the taxpayer.

DISCUSSION

At issue is whether the taxpayers qualify for nonrefundable capital gain credits to be applied against their Utah income taxes for 2008 and 2010. Before addressing the requirements necessary to qualify for the credits, the Commission should first address who has the burden of proof and how tax credit statutes are to be construed. Pursuant to Section 59-1-1417(1), the burden of proof is upon the petitioner in proceedings before the Commission (except in limited circumstances not present in this case). As a result, the taxpayers have the burden to show that they qualify for the capital gain credits at issue. Although the taxpayers argue that the Division has not shown that they do not qualify for the credits at issue, it is not the Division who has the burden of proof.

In addition, Section 59-1-1417(2)(b) provides that the Commission shall construe a statute providing a tax credit strictly against a taxpayer. The taxpayers ask the Commission to allow some latitude in interpreting the statute at issue in this case so that the purpose of the credit is not defeated. However, if the statute providing for the capital gain credit is ambiguous (i.e., open to interpretation), Utah law provides that the statute will be construed strictly *against* the taxpayer. On the other hand, if the plain language of the statute is deemed to be clear, the facts will be applied to this plain language to reach a decision, and the general

proposition that credits are strictly construed against the taxpayer will not be conclusive. *See MacFarlane v. Utah State Tax Comm'n*, 134 P.3d 1116, 2006 UT 18 (Utah 2006).

The requirements necessary to qualify for the capital gain credit are set forth in Section 59-10-1022(2) and (3). Section 59-10-1022(2) provides that a taxpayer may claim a nonrefundable tax credit equal to 5% of his or her capital gain on a capital gain transaction that occurs on or after January 1, 2008. There is no dispute that the taxpayers incurred a long-term capital gain resulting from the sale of TAXPAYER-1's BUSINESS-1 stock. Accordingly, a "capital gain transaction," as defined in Section 59-10-1022(1)(a), has occurred. There is also no dispute that the capital gain transaction occurred on or after January 1, 2008. It is clear that TAXPAYER-1 sold his BUSINESS-1 stock no earlier than June 30, 2008, the date of the merger between BUSINESS-1 and BUSINESS-2.[8]

Section 59-10-1022(3) provides additional requirements that must be met to qualify for the capital gain credit, which include: 1) the taxpayer must expend 70% or more of the gross proceeds of the capital gain transaction to purchase qualifying stock in a Utah small business corporation; 2) the expenditure must be made within a 12-month period after the day on which the capital gain transaction occurred; and 3) the taxpayer did not have a prior ownership interest in the Utah small business corporation in which it purchased the qualifying stock.

1. Section 59-10-1022(3)(a)(i). The parties disagree on whether the taxpayers expended 70% or more of the gross proceeds of the BUSINESS-1 stock sale to purchase qualifying stock of a Utah small business corporation (i.e., the CORPORATION stock), as required under Section 59-10-1022(3)(a)(i).[9] The Division contends that the taxpayers did not expend 70% or more of the gross proceeds they received from the

8 The taxpayers contend that the sale of TAXPAYER-1 BUSINESS-1 stock occurred on June 30, 2008, the date of the Merger Agreement between BUSINESS-1 and BUSINESS-2. The tax documents that BUSINESS-1 provided TAXPAYER-1 supports the taxpayers' argument that the sale did not occur earlier than this date.

9 The Division does not dispute that the CORPORATION stock the taxpayers eventually purchased was "qualifying stock," as defined in Section 59-10-1022(1)(d). Nor does the Division dispute that

sale of the BUSINESS-1 stock, which would equate to $$$$$ or more.[10] The Division acknowledges that the taxpayers exchanged intellectual property developed by TAXPAYER-1 and $$$$$ in cash for the CORPORATION stock. But, the Division contends that this exchange of assets is insufficient to meet the statutory requirement because the intellectual property primarily used to acquire the CORPORATION stock is not the "gross proceeds" that the taxpayers received when they sold the BUSINESS-1 stock.

The taxpayers acknowledge that they did not expend $$$$$ in cash to purchase the CORPORATION stock. But, they contend that they expended $$$$$ in assets to purchase the stock, specifically $$$$$ of intellectual property and $$$$$ of cash. The taxpayers argue that they should not be required to spend the cash they received from the BUSINESS-1 stock sale in order to qualify for the capital gain credit. They contend that it should be sufficient that they expended $$$$$ or more of their wealth to purchase the CORPORATION stock.

To decide which party's argument is more persuasive, the Commission should consider the specific language of Section 59-10-1022(3)(a)(i), which requires that "70% or more of the **gross proceeds** of the capital gain transaction are expended . . . to purchase qualifying stock in a Utah small business corporation" (emphasis added). The statute requires that at least 70% of the "gross proceeds" of the capital gain transaction to be expended. As a result, the Commission must determine whether the intellectual property and the $$$$$

CORPORATION is a "Utah small business corporation," as defined in Section 59-10-1022(1)(f).

10 TAXPAYER-1 received the gross proceeds from the sale of his BUSINESS-1 stock in two installments. He received most of the gross proceeds ($$$$$) in August 2008 and the remainder ($$$$$) on April 30, 2010 (18 months after the June 30, 2008 merger between BUSINESS-1 and BUSINESS-2). The gross proceeds from these two installment payments total $$$$$. 70% of these total payments is $$$$$.

The Commission addressed installment sales and the capital gain credit in *USTC Private Letter Ruling 13-004* (Dec. 13, 2013) ("*PLR 13-004*"). Redacted versions of Private Letter Rulings issued by the Commission can be reviewed at http://www.tax.utah.gov/commission-office/rulings. *PLR 13-004* (on page15) provides that the taxpayers would not qualify for a capital gain credit unless they invested 70% or more of the total gross proceeds from both installment payments associated with the BUSINESS-1 stock sale (i.e., $$$$$ or more) within 12 months "after the day the claimant enters into the installment sale contract." However, if the taxpayers are found to qualify for the credit, *PLR 13-004* also provides that they "may claim the [c]redit over time," as the installment payments were received and the capital gains were recognized in 2008 and 2010.

in cash that the taxpayers used to purchase the CORPORATION stock were "gross proceeds" of the sale of the BUSINESS-1stock.

In Section 59-10-1022(5), the Legislature authorized the Commission to define the term "gross proceeds" in rule. A rule defining "gross proceeds" has not been adopted. However, it may be helpful to consider the definition of "gross proceeds" or "proceeds" to help decide whether the Division's or taxpayers' argument is more persuasive. Black's Law Dictionary does not define the term "gross proceeds," but does define the term "proceeds," as follows:[11]

> Issues; income; yield; receipts; produce; money or articles or other thing of value arising or obtained by the sale of property; the sum, amount, or value of property sold or converted into money or into other property. Proceeds does not necessarily mean only cash or money. (cite omitted). That which results, proceeds, or accrues from some possession or transaction. (cite omitted). The funds received from disposition of assets or from the issue of securities.
>
> Proceeds includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of. The term also includes the account arising when the right to payment is earned under a contract right. Money, checks and the like are "cash proceeds." All other proceeds are "non-cash proceeds." (cite omitted).

This definition supports the Division's position by showing that the "proceeds" received from the sale of the BUSINESS-1 stock was money or cash, not the intellectual property later used to acquire a majority of the CORPORATION stock.[12] The "thing of value" arising or obtained by the sale of the BUSINESS-1 stock was money or cash. The "funds received from disposition" of the BUSINESS-1 stock was money or cash. This money or cash was the "cash proceeds" that the taxpayers received from the disposition of TAXPAYER-1 BUSINESS-1 stock and, as a result, should constitute the "gross proceeds" of the capital gain transaction.

The above definition does indicate that "non-cash proceeds" may also exist. But, the taxpayers do not claim to have received any intellectual property in exchange for TAXPAYER-1 BUSINESS-1 stock, and the

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11 Black's Law Dictionary 1084 (5th ed. 1979).

12 In the BUSINESS-1 Agreement, TAXPAYER-1, as owner of the intellectual property, licensed it to BUSINESS-1. At the same, time, he agreed to liquidate his stock in BUSINESS-1 as part of the BUSINESS-2 merger agreement. TAXPAYER-1 did not receive the intellectual property in exchange for his BUSINESS-1 stock. He received the same amount of money or cash as other BUSINESS-1 stockholders for the stock.

evidence does not support such an argument. Had the taxpayers received intellectual property in exchange for the BUSINESS-1 stock and then exchanged this property for the CORPORATION stock, the requirement of Section 59-10-1022(3)(a)(i) may well have been met.[13] However, the taxpayers received money, not intellectual property, in exchange for the BUSINESS-1 stock.

Furthermore, it is noted that the Legislature could have worded Section 59-10-1022(3)(a) to provide that a taxpayer could qualify for the capital gain credit if he or she expended **assets equal to 70% or more of the gross proceeds of the capital gain transaction**. Had it done so, the taxpayers' argument that they should be able to use any combination of their wealth to purchase the CORPORATION stock and qualify for the credit would be more convincing. But, the Legislature did not use such language. It specifically requires the "gross proceeds" of the capital gain transaction to be used, which in this case is the money or cash the taxpayers received from the sale of the BUSINESS-1 stock. For these reasons and keeping in mind that statutes providing for a credit are strictly construed against a taxpayer, the Commission should find that the intellectual property the taxpayers expended to purchase the CORPORATION stock was not "gross proceeds" of the sale of the BUSINESS-1 stock.

It does appear that the taxpayers expended $$$$$ in cash on CORPORATION stock. This $$$$$ of cash would be "proceeds" from the sale of the BUSINESS-1 stock, but this relatively small expenditure does

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13 This conclusion appears to be supported by Section 59-10-1022(1)(d)(iii)(C), which provides that "qualifying stock" can be issued for "money [or] other property, except for stock or securities." However, this subsection should not be read in isolation to mean that a taxpayer qualifies for a capital gain credit if the qualifying stock is purchased in exchange for any assets other than stock or securities. When this subsection is read in harmony with the other provisions of the Section 59-10-1022, the assets exchanged for the qualifying stock must be "gross proceeds" of the capital gain transaction.

It should be noted that there is a question about the value of the intellectual property that the taxpayers exchanged for the CORPORATION stock. The taxpayers claim that the intellectual property was worth $$$$$, which is based on TAXPAYER-1estimate of its value. TAXPAYER-1 develops intellectual property and has experience in this field. But, there has been no independent appraisal of the intellectual property submitted or other similar evidence that would support TAXPAYER-1 estimate of value. This issue, however, became moot once the Commission found that the intellectual property was not "gross proceeds" of the capital gain transaction.

not satisfy the 70% or more threshold set forth in Section 59-10-1022(3)(a). As mentioned earlier, the taxpayers would have had to expended $$$$$ or more of the BUSINESS-1 stock gross proceeds to meet this threshold. In conclusion, the taxpayers do not qualify for a capital gain credit because they did not expend 70% or more of the "gross proceeds" from the sale of the BUSINESS-1 stock to purchase the CORPORATION stock, as required under Section 59-10-1022(3)(a)(i).

2. Section 59-10-1022(3)(a)(ii). Because the taxpayers did not meet the requirement set forth in Section 59-10-1022(3)(a)(i), they do not qualify for the credits they claimed, even if they were found to satisfy the other requirements of Section 59-10-1022(3). However, there is serious doubt whether the taxpayers satisfy the other requirements of Section 59-10-1022(3). For example, Section 59-10-1022(3)(a)(ii) requires the taxpayers' purchase of the CORPORATION stock to occur "within a 12-month period after the date on which the capital gain transaction occurs" (i.e., within a 12-month period after the sale of the BUSINESS-1 stock). Because the BUSINESS-1 stock was sold in mid-2008, the taxpayers would have had to purchase the CORPORATION stock by mid-2009 to satisfy this requirement.

A contract shows that the taxpayers purchased the CORPORATION stock in 2010, which would be more than 12 months after the date of the BUSINESS-1 stock transaction. While TAXPAYER-1showed that he was deciding how much stock each employee of CORPORATION would receive as early as November 2008, he does not show that he "purchased" the CORPORATION stock in 2008. Although CORPORATION was registered as a business with the Utah Department of Commerce in October 2008, it was not registered as a "corporation" until February 6, 2009. It is unlikely that stock in a corporation could be purchased in 2008, as the taxpayers claims, before the corporation was incorporated in 2009. Furthermore, on March 24, 2009, TAXPAYER-1 stated in an email to the CFO that he still planned "to invest $$$$$ to give us a little working capital. One of our first expenses will probably be to engage a securities attorney to help us properly issue our company stock/options." As a result, it appears that no CORPORATION stock had even been issued prior to

March 24, 2009. The taxpayers provided no information to show when a securities attorney was hired to help CORPORATION issue is company stock.

For these reasons, it does not appear that taxpayers purchased the CORPORATION stock in November 2008, as they claim. The most convincing evidence proffered at the Initial Hearing shows that the taxpayers did not purchase the CORPORATION stock until 2010, which is outside the 12-month period to qualify for the credit. The taxpayers have the burden of proof, but have provided no law or court precedent showing that the emails and contracts entered into in 2008 constitute the "purchase" of stock before the end of the 12-month period. For these reasons, it also appears that the taxpayers have not met the requirement set forth in Section 59-10-1022(3)(a)(ii).

3. Section 59-10-1022(3)(b). In addition, it is questionable whether the taxpayers meet the requirement set forth in Section 59-10-1022(3)(b), which provides that prior to the purchase of the CORPORATION stock, the taxpayers did not have an ownership interest in CORPORATION. It is clear that a "venture" that later became CORPORATION was begun sometime prior to its incorporation in February 2009 and prior to TAXPAYER-1'S entering into the 2010 contract to purchase CORPORATION stock. TAXPAYER-1 and NAME-1were working together on the venture as early of August 9, 2008. In addition, the CORPORATION business was registered with the Utah Department of Commerce on October 11, 2008, at which time the taxpayers' home address was listed as the business's address. Furthermore, TAXPAYER-1 referred to "my new venture" in a November 1, 2008 email, and CORPORATION entered into contracts in late 2008 that were signed by TAXPAYER-1, as President of CORPORATION. These contracts also listed the taxpayers' home address as CORPORATION'S address.

These facts suggest that TAXPAYER-1 had some sort of ownership interest in the CORPORATION entity before it was incorporated in February 2009, before the CORPORATION stock was issued (which was subsequent to March 24, 2009), and before the taxpayers entered into the 2010 contract to purchase the

CORPORATION stock. The taxpayers have not indicated who other than TAXPAYER-1 would have owned the CORPORATION entity when it was first registered with the Utah Department of Commerce on October 11, 2008. Again, the taxpayers have the burden of proof and have not sufficiently shown that they did not have an ownership interest in CORPORATION prior to purchasing the CORPORATION stock. For these reasons, it also appears that the taxpayers have not met the requirement set forth in Section 59-10-1022(3)(b).

In conclusion, the Commission should find that the taxpayers have not met their burden to show that they meet all the requirements necessary to qualify for the capital gain credits they claimed on their 2008 and 2010 Utah tax returns. Accordingly, the Commission should sustain the Division's assessments in their entireties.

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Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains the Division's assessments for the 2008 and 2010 tax years in their entireties. 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, or emailed, 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

or emailed to:

taxappeals@utah.gov

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

DATED this _____ day of _____, 2015.

John L. Valentine
Commission Chair

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.