

19-1488

TAX TYPE: INCOME TAX

TAX YEAR: 2016

DATE SIGNED: 5/27/2020

COMMISSIONERS: J. VALENTINE, M. CRAGUN, R. ROCKWELL, L. WALTERS

GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

<p>TAXPAYER-1 & TAXPAYER-2,</p> <p>Petitioners,</p> <p>v.</p> <p>AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,</p> <p>Respondent.</p>	<p>INITIAL HEARING ORDER</p> <p>Appeal No. 19-1488</p> <p>Account No. #####</p> <p>Tax Type: Income Tax</p> <p>Tax Year: 2016</p> <p>Judge: Phan</p>
---	---

Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: TAXPAYER-1
REPRESENTATIVE FOR TAXPAYERS, Representative

For Respondent: RESPONDENT, Manager, Income Tax Auditing

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on March 10, 2020, for an Initial Hearing in accordance with Utah Code Ann. §59-1-502.5. Petitioners (“Taxpayers”) are appealing under Utah Code §59-1-501 a Utah individual income tax audit deficiency issued against them by Respondent (“Division”) for tax year 2016. In the audit, the Division had disallowed a gain on capital transactions credit claimed by the Taxpayers on their 2016 Utah Individual Income Tax Return. The Notice of Deficiency was issued on June 17, 2019. The amount of the additional tax assessed was \$\$\$\$\$. The interest accrued thereon as of the date of the Notice of Deficiency had been \$\$\$\$\$. Interest continues to accrue on the unpaid balance. There were no penalties assessed with the audit.

APPLICABLE LAW

Utah Code Ann. §59-10-1022 (2016)¹ provides a nonrefundable tax credit when capital gains are used to purchase qualifying stock in a Utah small business corporation under certain circumstances, 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:
 - (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

1 Unless otherwise indicated, the 2016 version of the substantive law is cited.

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.

....

Section 1244(c)(3), Internal Revenue Code defines small business corporation as follows:

(A) In general

For purposes of this section, a corporation shall be treated as a small business corporation if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$1,000,000. The determination under the preceding sentence shall be made as of the time of the issuance of the stock in question but shall include amounts received for such stock and for all stock theretofore issued.

Utah Code §59-1-1417 provides which party has the burden of proof and guidance as to statutory construction, as follows:

(1) In a proceeding before the commission, the burden of proof is on the petitioner . . .

(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.
- (c)

DISCUSSION

Utah Code Subsection 59-10-1022(2) allows a Utah individual income tax credit for the “total amount of the claimant’s . . . short-term or long-term capital gain on a capital gain transaction . . . and 5%.” However, pursuant to Subsection 59-10-1022(3), the tax credit may only be claimed 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 . . . did not have an ownership interest in the Utah small business corporation that issued the qualifying stock.”

The Taxpayers had claimed the capital gain transaction credit on their 2016 Utah individual income tax return and argued that they had qualified for the credit by purchasing shares of COMPANY-1. After auditing the return, the Division disallowed the credit. It was the Division’s contention that the Taxpayers did not meet the requirements of Utah Code Sec. 59-10-1022 because COMPANY-1 was not a “Utah small business” and because the Taxpayers already had an ownership interest in COMPANY-1 prior to the August 4, 2016 purchase the Taxpayers assert qualifies them for the credit. At the hearing, the Taxpayer explained that he thought he was properly entitled to claim the credit on his return. He acknowledged that he already had shares in COMPANY-1 prior to the purchase, but stated that his ownership interest was always less than %%% of the stock in the company. It was his contention that “ownership interest” should not mean a stock interest or it should mean a controlling interest in the stock. He stated he had an interest of less than %%% and not a controlling interest. It was his argument that the Division’s interpretation of “ownership interest” to mean any interest whatsoever was too narrow an interpretation of the statute. However, the information submitted in this matter is a bit unclear regarding how much ownership the Taxpayer had of COMPANY-1, because although he likely had less than a %%% interest in the common stock of the company, he was also a holder of Series C Preferred Stock.

In addition, the Taxpayer argued that COMPANY-1 was a “small business corporation” based on other measures than the statutory criteria. For instance, he indicated that in 2016 when he claimed the credit the business was nearly bankrupt. He also stated that the business stock only traded on the “Pink Sheets” and it was only the small companies that were thinly traded or large companies that had been delisted that traded on the Pink Sheets. He argued that generally if a

business trades on the Pink Sheets it is a small business. He also argued that the Tax Commission should follow the SBA's definition of "small business" rather than the Internal Revenue Code's definition. He represented at the hearing that the SBA's definition would allow up to ##### employees and \$\$\$\$ of paid in capital and argued that COMPANY-1 would qualify as a small business under those parameters. Therefore, he argued that the Division was applying too narrow of a definition of small business.

At the hearing, the Division provided as exhibits a copy of a December 10, 2008 Resolution of the Board of Directors of COMPANY-1 to issue ##### shares of Restricted Series C Preferred Stock to the Taxpayer in exchange for two parcels of real property located in CITY-1. There was another action from the COMPANY-1 board on January 23, 2015 where ##### of the Taxpayers' preferred shares were converted into ##### shares of "Common Stock Without a Restrictive Legend." The Taxpayer explained that he could sell these shares in small batches, but before doing so was required to file a report with the Securities and Exchange Commission stating that he was a less than %%% owner in COMPANY-1. The Taxpayer did not provide a copy of this SEC statement. The Division provided a copy of the Taxpayer's 1099 issued by COMPANY-2 for tax year 2016. This 1099 showed ##### separate days between March and August 4, 2016, where the Taxpayer sold common stock of COMPANY-1. (COMPANY-1 had changed its name to COMPANY-3., by this time, but for ease of reference, this decision will continue to refer to it as COMPANY-1.) The Taxpayer's sales of COMPANY-1 common stock were sold in batches from ##### shares to ##### shares and the total number of shares that the Taxpayer sold in 2016 was #####. His realized gain in 2016 was \$\$\$\$.

The Division indicated at the hearing that this showed the Taxpayer had ##### shares of the stock left. The consolidated balance sheets provided by the Division showed that as of December 2016 there were ##### shares of common stock, so this does support the Taxpayer's position that he had only a small interest in the company. Mathematically, if the taxpayer sold ##### of the ##### shares of common stock that the Taxpayer had acquired on January 23, 2015, by converting about %%% of his Series C Preferred Stock, he would have only ##### shares of that common stock left. However, on January 23, 2015, the Taxpayer had converted only %%% of his ##### Series C Preferred Stock. The same balance sheet indicated that as of December 31, 2016 there were only ##### outstanding shares of the Series C Preferred. Therefore, it remains unclear what the Taxpayer's ownership interest percentage in COMPANY-1 actually was.

The Taxpayer's purchase of COMPANY-1 shares that served as the basis for the Taxpayer claiming the capital gain transaction credit occurred on August 4, 2016. The Division

provided the August 4, 2016 Stock Purchase Agreement, pursuant to which the Taxpayer paid \$\$\$\$\$ to purchase another ##### shares of Series C Preferred stock. It was the Division's position that the Taxpayer already had an "ownership" interest in COMPANY-1 prior to this purchase and it is clear that the Taxpayer did have an ownership interest in both common stock and Series C Preferred Stock prior to this purchase.

In addition to disallowing the credit because of the prior ownership interest, the Division argued that the Taxpayer did not qualify for the capital gain transaction credit because COMPANY-1 was not a "small business corporation" for purposes of the credit. The Division provided a copy of COMPANY-1's 2016 consolidated balance sheets. These showed that the additional paid in capital in 2016 had been \$\$\$\$\$. It was the Division's position that COMPANY-1 did not qualify as a small business based on Utah law because it had more than \$\$\$\$\$ in paid in capital.

Upon review of the facts presented by the parties and the applicable law in this matter, the first consideration is that pursuant to Utah Code §59-1-1417(1) the Taxpayer has the burden of proof and because the issue in this appeal is a matter involving a tax credit, under Utah Code §59-1-1417(2)(b) the Commission must construe the statute providing the credit strictly against the taxpayer. Utah Code §59-10-1022 is clear and specific on what constitutes a "Utah small business corporation" for purposes of determining whether a taxpayer qualifies for the capital gains transaction credit. "Utah small business corporation" is defined at Subsection 59-10-1022(1)(f) to be "a small business corporation as defined in Section 1244(c)(3), Internal Revenue Code," with certain exceptions including that the "dollar amount listed in Section 1244(c)(3)(A) is considered to be \$2,500,000." Section 1244(c)(3)(A), Internal Revenue Code, provides "a corporation shall be treated as a small business corporation if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$1,000,000." Therefore, based on the clear and unambiguous terms of the Utah statute, COMPANY-1 is not a "small business corporation" for purposes of the capital gain transaction credit. The Division has demonstrated that the paid in capital alone in 2016 exceeded \$\$\$\$\$, therefore far exceeding the IRS's \$1,000,000 limit and the State of Utah's increase on that limit to \$\$\$\$\$. The Taxpayer does not qualify for the credit. The Taxpayer's arguments that the some broader definition should be applied and the Division's interpretation is too narrow lacks merit and has no support in law. The Division is clearly following the express provisions of Utah law.

Based on the fact that the Taxpayer's transaction does not meet the requirement that the investment be made in a "Utah small business corporation" the Commission need not look further

at the ownership interest requirement. However, it does appear that the Taxpayer has failed to meet this requirement as well because the Taxpayer did have an ownership interest in COMPANY-1. The Taxpayer owned both common and preferred shares of stock in COMPANY-1 prior to making the new stock purchase on August 4, 2016. Utah Code Subsection 59-10-1022(3)(b) provides that in order to qualify for the credit “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.” “Ownership interest” is not defined in the statute. Therefore, the Tax Commission is to apply its ordinary and accepted meaning.² The statute clearly does not say a “controlling interest” or a “more than %%% interest.” The Taxpayer had an ownership interest prior to the August 4, 2016 purchase and this would disqualify the Taxpayer. This strict interpretation is consistent with Utah Code §59-1-1417(2)(b) which requires the Commission to construe a statute providing a credit strictly against the taxpayer.

Based on the foregoing, the Taxpayers do not qualify for the capital gain transaction credit that they had claimed on their 2016 Utah individual income tax return and the audit deficiency should be upheld.



Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains the audit deficiency issued against the Taxpayers of additional individual income tax and the interest accrued thereon for tax year 2016. 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

² As noted by the Utah Supreme Court in *Ivory Homes v. Tax Commission*, 2011 UT 54, ¶21, regarding the interpretation of statutory language, “We presume that the legislature used each word advisedly and read each term according to its ordinary and accepted meaning.” And in *State v. Martinez*, 2002 UT 80, ¶8, “When examining the statutory language we assume the legislature used each term advisedly and in accordance with its ordinary meaning.”

Appeal No. 19-1488

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
CITY-1, 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 _____, 2020.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Rebecca L. Rockwell
Commissioner

Lawrence C. Walters
Commissioner

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.