LADEGAARD, JAMES C. & SANDRA L. (O) (2016)
Topic Code: C012 Capital Gain Deduction Document Reference: 16201046

Iowa Department of Inspections and Appeals
Administrative Hearings Division
Wallace State Office Building
502 East 9th Street, 3rd Floor
Des Moines, IA 50319

In the Matter of:	)	
	)	DIA No. 15IDR027
James C. Ladegaard and	)	(Rev. Docket No. 2013-200-1-0088)
Sandra L. Ladegaard	)	
2613 – 1st Street	)	
Arnolds Park, IA 51331	)	
	)	
v.	)	
	)	**PROPOSED ORDER**
Iowa Department of Revenue.	)	
	)	
INDIVIDUAL INCOME TAX	)	

Statement of the Case

Taxpayers James Ladegaard and Sandra Ladegaard appeal from an individual income tax assessment by the Iowa Department of Revenue, which denied a capital gain deduction taken by the taxpayers for income received during the 2011 tax year. The matter was scheduled for hearing on August 4, 2015. Prior to hearing, the parties entered into and submitted a comprehensive Stipulation of Facts, eliminating the need for an evidentiary hearing. The parties then agreed to submission of the protest upon written argument, pursuant to an agreed upon briefing schedule.

The record includes: the Protest petition filed by taxpayers on April 1, 2013; the Department's Answer to the Protest filed on March 27, 2015; Notice of Hearing issued on May 12, 2015; the joint Stipulation of Facts and attached exhibits A – E and 1 - 5, filed July 27, 2015; the Protestors' Written Argument, filed August 17, 2015; and the Brief of Iowa Department of Revenue, filed September 21, 2015. The Protestors waived their right to file a reply brief and the case was deemed submitted on September 25, 2015.

Issue Presented

Whether the Department correctly interpreted and applied Iowa law in disallowing a capital gain deduction claimed by the taxpayers for the sale of real estate during the 2011 tax year.

Findings of Fact

James Ladegaard practiced law in Iowa from 1970 until early 2007. (Stip. ¶ 1) From 1987 through his retirement, Ladegaard was a partner in a law firm located in Spirit Lake, Iowa. (Stip. ¶ 2) The issue in this case whether Ladegaard and his wife are entitled to claim Iowa capital gains deduction for income realized from the sale of Ladegaard's interest in an office building leased exclusively to the law firm.

Ladegaard acquired a one-third ownership interest in the office building on June 1, 1989. On May 1, 1992, Ladegaard acquired an additional one-sixth interest in the building, bringing his ownership stake to one half. At that time, Earl Maahs, one of Ladegaard's law partners, owned the other one-half stake in the building. (Stip. ¶ 3)

During Ladegaard's entire period of ownership of the building his law firm was the building's only tenant. (Stip. ¶ 8) Ladegaard and Maahs rented the building to the law firm on a triple net lease. Ladegaard and Maahs were paid rent by the firm for use of the building and were responsible for the cost of major repairs. The law firm was responsible for all other costs, including: real estate taxes, building insurance premiums, utilities, and maintenance expenses. Consistent with the practice followed by previous landlords and tenants of the building, the lease agreement was not put in writing. (Stip. ¶¶ 9-10)

As the building owners, Ladegaard and Maahs decided what expenses qualified as major repairs, the cost for which was to be borne by them individually. During the entire period of Ladegaard's ownership of an interest in the building, only two major repairs were undertaken: a parking lot repair in 2000 and a roof repair in 2009. (Stip. ¶ 10) In his capacity as owner of the building, Ladegaard did not perform any duties related to the day-to-day operation of the building. (Stip. ¶ 11) Ladegaard treated the office building as a rental property for income tax purposes, reporting rental income and expenses related to the building, including: interest, depreciation, and the cost of major repairs, on his personal income tax returns. (Stip. ¶ 19 & Taxpayer Exh. 5)

Ladegaard and Maahs did not maintain financial statements regarding rental of the building, such as profit and loss statements, income statements, balance sheets, or statements of cash flow. Ladegaard did not maintain any contemporaneous records regarding his time involvement with the building rental operations. (Stip. ¶ 12) As co-owners, Ladegaard and Maahs jointly made all decisions regarding rental of the building. (Stip. ¶ 13) They instructed their law firm employees on what building expense bills to pay and when to pay them, although payment was ultimately authorized either by Ladegaard or Maahs. (Stip. ¶ 13-14)

On May 1, 2011, Ladegaard sold his one-half share of the property to Maahs on an installment basis. Ladegaard and his wife Sandra claimed the net capital deduction for the installment payments received during 2011 on their Iowa individual income tax

return for that year. (Stip. ¶ 4) The Department disallowed the capital gain deduction and issued a notice of assessment of an additional $92.00 in tax plus interest to the Ladegaards on March 26, 2013. (Stip. ¶ 5 & Exh. 1) Ladegaard filed a timely protest of the assessment.

Ladegaard's material participation in the law firm business is not an issue in this case. (Stip. ¶ 15) Ladegaard's holding period in the building is also not an issue in the case. The parties agree that the sole issue presented is whether, for purposes of the Iowa net capital gain deduction "Ladegaard's material participation as a law partner in the tenant law firm's business should also apply to his business of renting the building to the law firm, where Ladegaard did not hold the building in his law practice business." (Stip. ¶ 17)

The taxpayers and the Department have stipulated that the outcome of this protest will control as to the applicability of the net capital gain deduction for any further years for which the taxpayers may seek to claim such deduction in connection with the 2011 installment sale of Ladegaard's one-half ownership stake in the building. (Stip. ¶ 20)

Conclusions of Law

Taxpayers James Ladegaard and Sandra Ladegaard challenge the Department's finding that income they received during the 2011 tax year from the sale of Ladegaard's interest in the office building that housed his law firm did not qualify for the Iowa capital gain deduction. They seek reversal of the assessment of additional income tax on proceeds from the sale. The challenged assessment was issued on March 7, 2013, less than six years after the 2011 return became due and the Department is not alleging fraud. Therefore, the burden of proof falls upon the taxpayers to prove that the assessment was made in error. *Camacho v. Iowa Dep't of Revenue and Finance,* 666 N.W.2d 537, 542 (Iowa 2003) (and cases cited therein); Iowa Code § 421.60(6)(c) (2011); 701 Iowa Admin. Code [IAC] 7.17(11)(d).[1]

All Iowa residents are required to pay state income tax on taxable income, as defined within Iowa Code chapter 422. The starting point for the calculation of taxable income is "adjusted gross income [AGI] before the net operating loss deduction as properly calculated for federal income tax purposes under the Internal Revenue Code." Iowa Code § 422.7. A number of exclusions, adjustments, and deductions from federal AGI are used to determine taxable income for purposes of Iowa income tax. Iowa Code §§ 422.5, 422.7, 422.9. This case concerns application of Code subsection 422.7(21), which allows net capital gain income to be deducted, or excluded, from taxable income. This provision allows a taxpayer to reduce AGI by subtracting:

[1] Unless otherwise noted, all citations herein are to the statutes and rules in place during 2011, the tax year underlying the assessment and the year of the real property sale underlying the taxpayer's claim.

> Net capital gain from the sale of real property used in a business, in which the taxpayer materially participated for ten years, as defined in section 469(h) of the Internal Revenue Code, and which has been held for a minimum of ten years, ...

Iowa Code § 422.7(21)(a)(1). ; *see also* 701 IAC 40.38 (implementing the capital gains deduction or exclusion). [2]

The parties agree that the ten-year ownership or holding period requirement of the Iowa capital gains deduction was met in this case. Ladegaard acquired one-half interest in the office building by purchasing a one-third interest in 1989 and one-sixth interest in 1992 and he sold his interest in the building in 2011. There is also no dispute regarding Ladegaard's material participation in the law firm that rented and occupied the building. He was a partner and active practitioner in the firm from 1987 until his retirement in early 2007.

The sole point upon which the parties disagree is whether Ladegaard's participation as a partner in the law firm that was the sole tenant of the building qualifies the sale of the building for the capital gain deduction when building was owned individually by Ladegaard and one of his law partners, rather than by the law firm. The Department contends that, because Ladegaard held his ownership interest personally, the building was not an asset of the business and Ladegaard's rental of the building to the law firm was a business activity separate and apart from operation of the law firm. In the Department's view, the operative question is whether Ladegaard materially participated in the real estate rental business and his material participation in the law firm is irrelevant.

Iowa Code section 422.7(21)(a)(1), allows a taxpayer to deduct from income "net capital gain from the sale of *real property used in a business, in which the taxpayer materially participated for ten years*, ... and which has been held for a minimum of ten years... ." The terms of the statute do not directly require the owner of the real property to hold the real property in the business in order to qualify for the deduction. The ownership of the real property "in the business" is clearly required under the administrative rules adopted by the Department to implement the capital gain deduction.

> Net capital gains from the sale of real property used in a business. Net capital gains from the sale of real property used in a business are excluded from net income on the Iowa return of the owner of a business to the extent the owner had *held the real property in the business* for ten or more

[2] Rule 40.38 refers to this reduction of federal AGI both as a "deduction" and as an "exclusion." These terms are used interchangeable herein to indicate a reduction of taxable income.

> years and the owner had materially participated in the business for at least ten years. ... (emphasis added)

701 IAC 40.38(7) (applicable to transactions on or after January 1, 1998).[3] The taxpayers contend that this rule represents an overly restrictive interpretation of Code subsection 422.7(21).

The capital gain deduction established by Code subsection 422.7(21) exempts income from tax and must be narrowly construed. Although statutes imposing tax are construed strictly against the taxing body, the opposite rule of construction applies to statutes exempting income from taxation.

> A party seeking a tax exemption bears a heavy burden. As our prior cases demonstrate, taxation is the rule, exemption is the exception. *Van Buren County Hosp. & Clinics v. Bd. of Rev.*, 650 N.W.2d 580, 586 (Iowa 2002) (noting that exemptions exist only as a matter of legislative grace and are generally disfavored as inequitable and unfair). Exemptions from taxation, therefore, are "'construed strictly against the taxpayer and liberally in favor of the taxing body.' " *Ranniger v. Iowa Dep't of Revenue & Fin.*, 746 N.W.2d 267, 269 (Iowa 2008) (quoting *Iowa Auto Dealers Ass'n v. Iowa Dep't of Revenue*, 301 N.W.2d 760, 762 (Iowa 1981)).

Iowa Network Services, Inc. v. Iowa Dep't of Revenue, 784 N.W.2d 772, 776 (Iowa 2010). "Doubts are resolved against exemption." *Hy-Vee Food Stores, Inc. v. Iowa Dept. of Revenue*, 379 N.W.2d 37, 39-40 (Iowa Ct. App. 1985).

Rule 40.38(7) was enacted through the formal rule-making procedures outlined in the Iowa Administrative Procedure Act and is published in the Iowa Administrative Code. *See* Iowa Code §§ 17A.4; 17A.6. The rule represents the Department's interpretation of the capital gain deduction found in code section 422.7(21), as it applies to the sale of the real property of a business by an individual who meets the criteria for ownership of the business and material participation in the business. *See* IAB [Iowa Admin. Bulletin]

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[3] The rule applicable to transactions during the 1990 – 1997 tax years contains a similar business ownership requirement:

> Net capital gains from sales or exchanges of real property, tangible personal property, or other *assets of a business owned by the taxpayer* for a minimum of ten years and in which the taxpayer has materially participated for a minimum of ten years. Net capital gains from the sales or exchanges of real property, tangible personal property, or other *assets from a business the taxpayer has owned* for ten years and in which the taxpayer materially participated as defined in Section 469(h) of the Internal Revenue Code for ten years qualify for the capital gain deduction. (emphasis added)

701 IAC 40.38(1).

Vol. XXI, No. 15 (1/27/1999), ARC 8635A (rule 40.38(7) adopted and filed emergency after notice).

The Director of the Department of Revenue is responsible for the administration of tax laws in Iowa. Iowa Code § 421.17(1). The legislature has granted the Director the express authority to prescribe all rules not inconsistent with law "necessary and advisable" for detailed administration of the sales and use tax laws and to effectuate their purpose. Iowa Code § 422.68(1). "Bearing in mind the practical considerations involved in the legislature's vesting the department with discretion to enforce the laws, it follows the department has the authority to define terms necessary to fulfill its responsibility." *City of Sioux City v. Iowa Dept. of Revenue and Finance,* 666 N.W.2d 587, 590 (Iowa 2003). Absent direct conflict with an applicable statute, definitions of terms and interpretations of Code chapter 423 enacted by the Department through administrative rules will be reversed by the court only if it is found to be "irrational, illogical, or wholly unjustifiable." Iowa Code § 17A.19(10)(l); *see, e.g., Ranniger v. Iowa Dept. of Revenue and Finance,* 746 N.W.2d at 268; *City of Sioux City,* 666 N.W.2d at 590; *City of Marion v. Iowa Dept. of Revenue and Finance,* 643 N.W.2d 205, 207 (Iowa 2002).

Here, Ladegaard held his half interest in the office building as a personal asset, not as an asset of the business. Ladegaard materially participated in the practice of law with the firm that the leased the building, but this business did not own the office building. This scenario falls outside of the criteria of the Iowa capital gain deduction as articulated in rule 40.38(7). Under this rule the net capital gain deduction to gains from "the sale of real property used in a business are excluded from net income on the Iowa return of the owner of a business *to the extent the owner had held the real property in the business* for ten or more years and the owner had materially participated in the business for at least ten years. …"

Although the language of subsection 422.7(21)(a) could be interpreted more broadly than done within rule 40.38, the terms of the statute do not demand the broader construction urged by the taxpayer in this case. The Department has consistently maintained the requirement of business ownership of real estate as a prerequisite of the subsection 422.7(21)(a) exemption for more than 25 years. The current version of the rule has been in place since 1999. The legislature has had ample opportunity to revise the statute to countermand the agency's interpretation and has not done so, lending "tacit approval" to the Department's action. *See City of Sioux City,* 666 N.W.2d at 592; *City of Marion,* 643 N.W.2d at 207-08.

Rule 40.38(7) represents a strict construction of the capital gain deduction that is neither unreasonable nor inconsistent with the terms of the statute. The agency rule is binding in this proceeding. The Protestor can prevail only if the record supports a finding that he materially participated in rental of the office building. The definition of material participation set out in section 469(h) of the Internal Revenue Code (IRC) is

incorporated into subsection 422.7(21). This section provides that "[a] taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is-- (A) regular, (B) continuous, and (C) substantial." 26 U.S.C. § 469(h)(1). Relevant factors in analyzing material participation include: whether the business is the taxpayer's principal business (although, a taxpayer may have more than one business); how regularly the taxpayer is present at the business; and whether the taxpayer performs all functions of the business (although, the use of employees or contractors to perform daily functions in a business will not prevent the taxpayer from qualifying as materially participating in the business). 701 IAC 40.38(1)(c).

The stipulated facts show minimal activity by Ladegaard in relation to the business of renting the office building. This activity fell far short of the substantial involvement required to support a finding of material participation in that business activity. Therefore, I conclude that the Department correctly found that the taxpayers in this case were not entitled to exclude the net gain from the sale of the office building as capital gain for Iowa tax purposes. The assessment of tax and interest upon this income must be upheld.

Order

The assessment of income tax and interest for the 2011 tax is AFFIRMED. The taxpayers shall pay the full amount of the assessed tax plus all accumulated interest. The Department shall take any action necessary to implement and enforce this decision.

Issued on August 3rd, 2016.

Christie J. Scase
Administrative Law Judge

NOTICE

Any aggrieved party has 30 days, including Saturdays, Sundays and legal holidays, of the date of this Proposed Decision to file an appeal to the Director of the Department of Revenue. 701 IAC 7.17(8)(d). The appeal must be made in writing. The appeal shall be directed to:

Office of the Director
Iowa Department of Revenue
Hoover State Office Building
Des Moines, Iowa 50319

Copies to:

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2613 – 1st Street
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