Brandt, Dale D. (O) (2016)
Topic Code: CO12 Capital Gains Deduction **Document Reference: 16201089**

Iowa Department of Inspections and Appeals
Administrative Hearings Division
Wallace State Office Building – Third Floor
Des Moines, IA 50319

In the Matter of:	)	
	)	DIA No. 14DORFC018
Dale D. Brandt	)	(Rev. Docket No. 2013-200-1-0057)
6128 Stapleford Circle	)	
Dallas, TX 75252	)	
	)	
v.	)	
	)	**PROPOSED DECISION**
Iowa Department of Revenue.	)	
	)	
INDIVIDUAL INCOME TAX	)	

Statement of the Case

Taxpayer Dale Brandt protests an assessment by the Iowa Department of Revenue that disallowed a capital gain deduction and imposed additional tax, penalty, and interest on Brant and his wife Paula Brandt for the tax year ending December 31, 2010. A contested case hearing for the protest was scheduled to be held on June 26, 2015. Prior to that date, the parties entered into a comprehensive stipulation of facts, eliminating the need for an evidentiary hearing, and agreed to a scheduled for submission of the protest through briefs and oral argument.

The record includes a *Joint Stipulation of Facts by Dale D. Brandt and Iowa Department of Revenue* and the attached supporting documents (Protestor's Exhibits 17 and Department Exhibits A-J). After briefs were filed, oral argument was conducted at the Wallace State Office Building in Des Moines on October 2, 2015. Arguments were presented by attorney Gary Streit for the taxpayer and Assistant Attorney General Hristo Chaprazov for the Department and the case was submitted.

Ruling on Motion to Strike: The taxpayer filed an initial brief on July 31, 2015. The Department filed its brief on August 31, 2015. The taxpayer filed a reply brief on September 14, 2015. The Department filed a Motion on September 16, 2015, seeking an order striking portions of the taxpayer's reply brief dealing with the merits of an argument concerning the definition of retirement. Alternatively, the Department sought leave to file a response to the reply brief. The Department submitted argument in response to the taxpayer's challenge to definition of retirement in a brief in response to the reply brief, which was delivered with the motion.

A ruling on the Motion to Strike was issued at the hearing on October 2nd, prior to the submission of oral argument. The Protest Petition set forth the taxpayer's challenge to the definition of the word "retirement" used by the Department for purposes of applying

the special rule regarding material participation by a retired or disabled farmer – now found in 701 IAC 40.38(1)(f)(1). Indeed, this was the sole error articulated in the petition. The taxpayer set forth argument on an alternative claim of error and omitted argument regarding the definition of retirement from his initial brief. In its responsive brief, the Department argued that the taxpayer had abandoned or waived his challenge to the retirement definition. The taxpayer's reply brief again advanced his challenge to the definition of retirement used by the Department. The taxpayer's protest raised this claim and facts relevant to the claim were included in the Joint Stipulation of Fact. The Motion to Strike was denied, the Department's response to the reply brief was accepted, and the parties both addressed taxpayer's challenge to the retirement definition during argument.

Issue presented

Whether the Department correctly interpreted and applied Iowa law in disallowing a capital gain deduction claimed by the taxpayer for the sale of real property during the 2010 tax year.

Findings of Fact

The material facts underlying were stipulated by the parties and are not in dispute. Dale Brandt was born on April 27, 1946. He turned 62 on April 27, 2008. (Stip. 1) Mr. Brandt received his first Social Security retirement payment in June of 2008. Between early 2004 and December 10, 2010, Mr. Brandt did not engage in any activity as an employee or a self-employed business person. (Stip. 7)

This proceeding concerns income Mr. Brandt and his wife received from the sale of farm land in December of 2010. On or about February 7, 1978, Dale D. Brandt and his wife Paula A. Brandt (the Brandts) purchased a farm in Kossuth County Iowa (the original farm). Mr. Brandt actively farmed the original farm from February of 1978 through April 2002. (Stip. 2) In April of 2002, the Brandts exchanged the original farm for another farm in Kossuth County Iowa (the replacement farm), through a transaction that qualified as a like-kind exchange under Internal Revenue Code section 1031. As a result of this transaction, the Brandts received a carry-over tax basis in the replacement farm. (Stip. 3)

Mr. Brandt actively farmed the replacement farm from the date of possession through the end of 2003 and reported self-employment income from this activity. (Stip. 4) From 2004 through 2009, the Brandts leased the replacement farm on a cash rent basis. Mr. Brandt did not actively farm, participate in crop production, or perform other management activities related to the replacement farm after 2003. (Stip. 5) In December 0f 2010, the Brandts sold the replacement farm and realized a long-term capital gain from the sale. (Stip. 8 & 9)

The Brandts owned the original farm and the replacement farm for approximately 32 years. Mr. Brandt actively farmed the properties for 25 of those years. (Stip. 2 – 5) The Brandts reported capital gain income of $713,060.00 from the sale of the replacement farm and claimed a capital gain deduction of $713,060.00 on their 2010 Iowa Individual Income Tax return. (Stip. 9 & Exh. 7)

The Iowa Department of Revenue conducted an audit of the Brandts' Iowa Individual Income tax return for tax year 2010; disallowed the entire capital gain deduction. The Department notified the taxpayers of the adjustment and on January 8, 2013 issued an assessment for additional tax liability totaling $66,470.00; a $3,323.50 penalty; and accrued interest of $5,583.48. (Exh. 2) Mr. Brandt filed a timely protest of the assessment, initiating this proceeding.

The taxpayer argues that he met the holding period and active management requirements for claiming the Iowa capital gain deduction upon sale of the replacement farm because he owned and actively managed the original and replacement farms for more than 10 years before he retired from farming at the end of 2003. The Department contends that Mr. Brandt fails to meet the material participation requirement of the capital gain deduction under either the standard rule or special rule for retired farmers because he was not actively farming or managing the property during the ten years immediately preceding the date of the sale or during five of the eight years before his retirement.

Conclusions of Law

All residents and nonresidents are required to pay tax on taxable income earned in Iowa. Iowa Code §§ 422.5, 422.8 (2009).[1] Iowa law authorizes the Department of Revenue to examine individual income tax returns and determine the tax due. If the tax found is greater than the amount paid, the Department shall compute the amount due, together with applicable interest and penalty, and issue a notice of assessment. Iowa Code § 422.25(1). "A taxpayer may appeal to the director for revision of the tax, interest, or penalties assessed at any time within sixty days from the date of the notice of assessment of tax, additional tax, interest, or penalties." Iowa Code § 422.28.

In most cases, it is incumbent upon a taxpayer challenging a tax assessment to show that error in the assessment. The burden of proof shifts to the Department to establish allegations of fraud and in some cases where an assessment is not made within six years after a return became due. In all other cases, the burden of proof is upon the taxpayer. Iowa Code § 421.60(6)(c); 701 Iowa Admin. Code [IAC] 7.17(11)(d). Here, the taxpayer challenges an assessment for tax year 2010 that was issued on January 8, 2013, less than six years after the return became due and the Department is not alleging fraud.

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[1] The law governing individual income tax liability for tax year 2010 applies in this case. Except as otherwise noted, all references to Iowa statutes and Department rules herein will be to the version of the statutes and rules in place when the return for the 2010 tax year was due.

Therefore, the burden of proof falls upon the taxpayer 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).

Here, the taxpayer argues that the capital gain adjustment delineated in Code section 422.7(21)(a)(1) applies to sale of the replacement farm. Section 422.7(21) is a tax exemption statute. As such, this provision must be "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), citing *Iowa Auto Dealers Ass'n v. Iowa Dep't. of Revenue,* 301 N.W.2d 760, 762 (Iowa 1981) and *Heartland Lysine, Inc. v. State,* 503 N.W.2d 587, 588-89 (Iowa 1993). All doubts must resolved in favor of taxation. *Sherwin-Williams Co. v. Iowa Dep't of Revenue,* 789 N.W.2d 417, 424 (Iowa 2010).

The starting point for the calculation of net taxable net income is the adjusted gross income (AGI) as properly calculated under the federal Internal Revenue Code (IRC). Iowa Code § 422.7. Iowa law allows a number of exclusions, adjustments, and deductions from AGI that are used to determine taxable income for purposes of Iowa income tax. Iowa Code §§ 422.5, 422.7, 422.9. The controversy in this case concerns application of Iowa Code section 422.7(21)(a)(1), which allows a taxpayer to reduce AGI by deducting:

> 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, or from the sale of a business, as defined in section 423.1, in which the taxpayer was employed or 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. . . .

Both the ten-year ownership requirement and the ten-year material participation requirement must be met to qualify for the Iowa capital gain deduction.

The taxpayer in this case obtained the property sold – the replacement farm – in a like-kind exchange under Internal Revenue Code section 1031 (26 U.S.C. § 1031). The holding period of replacement property acquired in a section 1031 exchange and used in a trade or business includes the holding period of the relinquished property. *See* 26 U.S.C. §§ 1223(1), 1231(d), 1031. The taxpayer owned the original and replacement farms for a collective total of 32 years. The Department recognizes that the taxpayer met the ownership, holding-period requirement. The question upon which the parties disagree is whether the taxpayer met the requirement for material participation in the trade or business.

Iowa Code section 422.68(1) affords the Director of the Iowa Department of Revenue "the power and authority to prescribe all rules not inconsistent with the provisions of this chapter, necessary and advisable for its detailed administration and to effectuate its purposes." The rules the Department has adopted to implement the capital gain deduction incorporate the 10 year holding period and material participation requirements of Iowa Code section 422.7(21)(a)(1) and the definition of material participation from the referenced federal statute.

> 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 years and the owner had materially participated in the business for at least ten years. For purposes of this provision, material participation is defined in Section 469(h) of the Internal Revenue Code and described in detail in subrule 40.38(1), paragraph "c."

701 IAC 40.38(7) (April 2010) (rule applicable to net capital gains received in tax years beginning on or after January 1, 1998; equivalent to current rule 40.38(2)).

> Material participation in a business if the taxpayer has been involved in the operation of the business on a regular, continuous, and substantial basis for ten or more years at the time assets of the business are sold or exchanged. If the taxpayer has involvement in a business which meets the criteria for material participation in an activity under Section 469(h) . . . for ten years or more immediately before the sale or exchange of the assets of a business, the taxpayer shall be considered to have satisfied the material participation requirement for this subrule.

(emphasis added). 701 IAC 40.38(1)(c) (April 2010).

The rules include guidance and examples to clarify how the material participation test applies to a number of specific circumstances, including the sale of property by a retired farmer. When the tax return at issue here was filed in 2010, the rule stated:

> ● A retired or disabled farmer is treated as materially participating in a farming activity for the current year if the farmer materially participated in the activity for five of the last eight years before the farmer's retirement or disability. That is, the farmer must have been subject to self-employment tax in five of the eight years before retirement or disability and had to have been either actively farming so the income was reported on Schedule F or materially participating in a crop-share activity for five of those eight last years prior to retirement or disability.
>
> EXAMPLE. Fred Smith was 80 years old in 1991 when he sold 200 acres of farmland he had owned since 1951. Mr. Smith retired in 1981. In the last

> eight years before retirement, Mr. Smith was paying self-employment tax on his farm income which was reported on Schedule F for each of those eight years. In the years before he sold the farmland, Mr. Smith was leasing the farmland on a cash-rent basis, whereby Mr. Smith would not be considered to be materially participating in the farming activity. Because Mr. Smith had material participation in the farmland in the eight years before retirement, Mr. Smith was considered to have met the material participation requirement, so the capital gain qualified for the Iowa capital gain deduction.

701 IAC 40.38(1)(c)(7) (April 2010) (first bullet point). The terms "retired" and "retirement" were not defined within rule 40.38 in 2010. Based on review of section 469(h) of the Internal Revenue Code (IRC) and the IRC sections cross-referenced therein, the Department concluded and regularly advised that, in this context, a person retired upon receiving social security old age or retirement benefits. *See* Jt. Stipulation, Dept. Exhibits B-E.

The definition of material participation in subsection 469(h) of the IRC is incorporated into the section 422.7(21)(a)(1) capital gain deduction.[2] IRC subsection 469(h) provides, in relevant part:

> (h) Material participation defined – For purposes of this section –
> (1) *In general.* – 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.
>
> * * *
>
> (3) *Treatment of certain retired individuals and surviving spouses.* – A taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year.
>
> * * *

[2] IRC subsection 469(h) is not itself a statute directly related to capital gains and does not contain a duration requirement. Rather, IRC Section 469 addresses the annual deductibility of passive activity losses. Passive activity losses can typically be deducted only to the extent the losses offset any income the activity generates. Under subsection 469(h), a taxpayer may deduct losses exceeding income in any given year if they can establish material participation in the underlying business activity.

26 U.S.C. § 469(h)(1), (3).

IRC section 2032A is an estate tax provision establishing an alternative valuation rule applicable to certain farmland and other real property used in business. Several prerequisites must be met in order for property to qualify for the option of using this alternate valuation, including duration of ownership and material participation requirements.

> (C) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which—
>
> (i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use by the decedent or a member of the decedent's family, and
>
> (ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business,

26 U.S.C. § 2032A(b)(1)(C). The subsection 469(h)(3) definition of material participation, incorporates special rules established by IRC subsections 2032A(b)(4) and (5) for purposes of assessing material participation in the operation of a farm or other business by a retired or disabled farmer or surviving spouse in the context of section 2032A(b)(1)(C)(ii). The rule in section 2032A(b)(4) applies to decedents who are retired or disabled, defining retirement as "receiving old-age benefits under title II of the Social Security Act for a continuous period ending on the date of death." 26 U.S.C. § 2032A(b)(4)(A)(i).

In 2012, the Department adopted the following amendment to the rule concerning material participation by a retired farmer.

> (1) A retired or disabled farmer is treated as materially participating in a farming activity for the current year if the farmer materially participated in the activity for five of the last eight years before the farmer's retirement or disability. That is, the farmer must have been subject to self-employment tax in five of the eight years before retirement or disability and had to have been either actively farming so the income was reported on Schedule F or materially participating in a crop-share activity for five of those eight last the last eight years prior to retirement or disability. The farmer must be receiving old-age benefits under Title II of the Social Security Act to be considered a retired farmer.
>
> EXAMPLE. Fred Smith was 80 years old in 1991 2011 when he sold 200 acres of farmland he had owned since 1951. Mr. Smith retired in 1981 2001 when he began receiving old-age benefits under Title II of the Social Security Act. In the last eight years before retirement, Mr. Smith was paying self-employment tax on his farm income which was reported on Schedule F for each of those eight years. In the years before he sold the

> farmland, Mr. Smith was leasing the farmland on a cash-rent basis, whereby Mr. Smith would not be considered to be materially participating in the farming activity. Because Mr. Smith had material participation in the farmland in the eight years before retirement, Mr. Smith was considered to have met the material participation requirement, so the capital gain qualified for the Iowa capital gain deduction

IAB Vol. XXXIV, No. 16 (2/8/2012) p. 1055, ARC 0005C (Notice of Intended Action, Jt. Stipulation, Dept. Exhibit F, at p. DOR-4). The Legislative Services Agency prepared a fiscal impact summary for the changes to rule 40.38, pursuant to Code section 17A.4(4), and concluded the rule amendments would have no fiscal impact. LSA, Administrative Rules – Fiscal Impact Summaries, 3/12/2012 (Jt. Stipulation, Dept. Exhibit H, at p. DOR-11). After the comment period, the rule change was adopted and filed without change. IAB Vol. XXXIV, No. 20 (4/4/2012) p. 1341, ARC 0073C (Jt. Stipulation, Dept. Exhibit I).

The taxpayer in this case raises two challenges to the Department's interpretation and application of the Iowa capital gain deduction. First, he alleges that the Department erred by applying the 2012 amendment of sub-rule 40.38(1)(c)(7), even though he sold the replacement farm in 2010, before the rule provided that a farmer must be receiving Social Security retirement benefits to be considered retired. The taxpayer argues that the plain language of the pre-amendment rule supports his use of the capital gain deduction, arguing that the rule should be interpreted using a common understanding of the term retired farmer to mean a farmer who has retired from farming. Mr. Brandt stopped actively farming the land in 2004. He actively farmed the original or replacement farm during the eight years prior to 2004. Under the taxpayer's reading of the pre-amendment rule, he meets the retired-farmer material participation requirement and is entitled to claim the capital gain deduction even though he did not begin collecting Social Security until 2008.

This challenge to the assessment is viable only if the 2012 amendment to rule 40.38(1)(c)(7) represented a change in how the capital gain deduction was applied to retired farmers. Not all amendments of administrative rules represent a change in the law. An amendment to a statute or rule may indicate the intent to change the existing law or merely to clarify it, depending upon the circumstances." *Hutchison Nursing Home, Inc. v. Burns*, 236 N.W.2d 312, 316 (Iowa 1975); *see also State ex rel. Schuder v. Schuder*, 578 N.W.2d 685, 687 (Iowa 1998); *Iowa Elec. Light & Power Co. v. Iowa Utilities Bd.*, 442 N.W.2d 99, 100, n. 1 (Iowa 1989). The hearing record includes informal advice from the agency in 2006 and 2011, showing a consistent interpretation of "retired farmer," to mean a farmer collecting Social Security old-age benefits. The rule amendment was deemed to have no significant fiscal impact.

As detailed above, Iowa Code subsection 422.7(21)(a)(1) incorporates the IRC section 469(h) definition of material participation. The special treatment of taxpayers who have

retired from farming flows from IRC section 469(h)(3) and the subsections of IRC section 2032A(b) that are cross-referenced therein. A person is retired, for purposes of section 2032A(b), only if the person was receiving Social Security old-age benefits. The relevant provisions of IRC sections 469(h) and 2032A have not been amended since 2004 and the taxpayer has not proven that the 2012 amendment of rule 40.38(7) represented a change in the Department's interpretation of the law. Examination of the statutory basis for retired-farmer rule, the Department's consistent interpretation of the rule, and the history of the 2012 amendment compel me to conclude that the rule amendment represented a clarification of existing law, not a change in the law.

Mr. Brandt stopped actively farming the land in 2004, began receiving Social Security old-age benefits in 2008, and sold the land in 2010. Brandt did not materially participate in farming the land five or more of the last eight years before he became a retired farmer by receiving Social Security old-age benefits. He was not entitled to claim a capital gain deduction for proceeds from the sale of the replacement farm under the retired farmer provision.

In a second alternative challenge to the denial of the capital gain deduction, the taxpayer argues that the Department misinterpreted of the 10 year material participation requirement of Iowa Code section 422.7(21)(a)(1) by the material participation to have occurred *during the ten years immediately before the sale.* He asserts that this aspect of the rule is more restrictive than and inconsistent with Code section 422.7(21)(a)(1) and, therefore, invalid. A virtually identical challenge to rule 40.38(1)(c) was recently rejected by the Iowa Court of Appeal. *Lance v. Iowa State Bd. of Tax Review,* No. 141144, 871 N.W.2d 703 (Table) (Iowa Ct. App. 9/10/2015) (unpublished slip opinion, available at 2015 WL 5287134). The court addressed all aspects of the argument advanced by Brandt in this case and found that the rule was consistent with the language of Code section 422.7(21) and in harmony with IRC section 426(h). *Id.* Slip. Op. at pp. *4-*5. The *Lance* decision compels me to uphold sub-rule 40.38(1)(c) and the Department's application of the rule in this case.

The taxpayer has failed to prove that the Department erred in disallowing his claim of the capital gain deduction and the assessment at issue here must be upheld.

Order

The challenged individual income tax assessment for the 2010 tax year is affirmed. The Brandts shall pay the full amount of the assessed tax and penalty, plus all accumulated interest. The Department shall take any action necessary to implement and enforce this decision.

Issued on June 14th, 2016.

Christie J. Scase
Administrative Law Judge

Copies to: ATTORNEYS FOR TAXPAYER

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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