## FCG VALUATION CASE E-FLASH

### Authored by John Walker and Chris D. Treharne, ASA, MCBA, BVAL of Gibraltar Business Appraisals, Inc. a member firm of FCG

### Issue 13:7

*William M. McNeil and Catherine A. McNeil, Petitioners, v. Commissioner of Internal Revenue, Respondent*
T.C. Memo 2011-109; Docket No. 9238-09; May 23, 2011

Following its ruling and logic in Tempel v. Commissioner, 136 T.C. No. 15 (2011) [refer to E-Flash 13:4], the Tax Court determined that state income tax credits are capital assets and the sale of such credits should not be taxed as ordinary income. Further the Tax Court again determined that the holding period for such credits begins upon receipt of the credit (i.e., after the donation of the conservation easement, not upon the acquisition of the real property underlying the conservation easement).

**TAKEAWAY**
Relying on its recent precedent in Tempel, the Tax Court determined that reductions in tax liabilities are not accessions to wealth. As a result, the sale of state income tax credits cannot be taxed as ordinary income. Additionally, all property that does not meet one of the eight exceptions under IRC § 1221 or the substitute for ordinary income doctrine are capital assets.

**THE FACTS**
William M. McNeil and Catherine A. McNeil ("Petitioners" or the "McNeils," collectively) were partners in McNeil Ranch, LLC ("the Partnership"). During 2003, the Partnership sold two separate qualified conservation easements of land in Colorado to qualified organizations in bargain sales. As a result of the donations, the Petitioners received $260,000 in state income tax credits.

The State of Colorado granted an income tax credit equal to 100 percent of the donated value up to $100,000. If the donated value was in excess of $100,000, the amount in excess was granted a credit of 40% of the value in excess of $100,000, with a maximum credit of $260,000.

The State of Colorado permitted credit recipients to use the credits in order to receive a refund, with a maximum refund of $50,000. Unused credits could offset future income tax for up to 20 years. However, transferees of such credits could only use the credit to offset their tax liability, and transferees were not permitted to receive a refund or transfer their credits.

On December 18, 2003, the Partnership sold $231,600 worth of credits for net proceeds of $178,332.
On its 2003 Form 1065, the Partnership reported charitable deductions associated with the bargain sales and reported long-term gains associated with the sales of conservation easements and the sale of the tax credits. The income and deductions from the Partnership flowed through to the Petitioners and they reported the tax items on their Form 1040 consistent with Form 1065.

In 2005, the Partnership sold another conservation easement in a bargain sale. The sale allowed the Partnership to collect another conservation easement tax credit, which the Partnership sold on December 15, 2005.

The IRS disagreed with the Petitioners' computation of tax liability and determined that gains should be taxed as ordinary income rather than as capital gains.

**DISCUSSION**

As in Tempel, the McNeils' state income tax credits did not properly fit any definition of the term capital asset under IRC § 1221. However, the Tax Court determined that the credits did not apply to any of the eight exceptions under IRC § 1221 nor the substitute for ordinary income doctrine. As a result, the income tax credits qualified as capital assets and the gains on the sales of the assets should be taxed at capital gains rates.

The Tax Court concluded that the Petitioners did not have a basis in the credits because the credits were granted by (as opposed to sold by) the state. Because the McNeils did not acquire their credits via purchase, they were not entitled to allocate easement costs to their basis in the credits.

Finally, the Court determined that the gains on the sales of the state income tax credit were short-term. The Tax Court found that the Petitioners did not have a right to the credit until the credit was granted by the state. The credits were not granted until after the donation of the easement, so the Petitioners' holding period in the credits began when the credits were granted, not when they bought the land which was donated in the conservation easement

**CONCLUSION**

Following its ruling and logic in Tempel v. Commissioner, the Tax Court concluded that, although state income tax credits did not fall under easily identifiable definition of capital asset, the credits did not meet any of the exceptions under IRC § 1221 or the substitute for ordinary income doctrine. Because the credits did not meet any of the exceptions or the doctrine, the income tax credits were capital assets. Accordingly, the sale of capital assets such as the credits should be treated as capital gains rather than ordinary income. Also, the state's granting – rather than selling – of the tax credits prevented holders of the credits from acquiring a basis in them. The Court further determined that the date of acquisition of the tax credit (not the date of acquisition of the land underlying the conservation easement, which was the basis for the credit) determined whether the sale of the credit was a short-term or long-term gain.

*********************************************************************************************