

## FCG VALUATION CASE E-FLASH

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Issue 13:4**

*George H. Tempel and Georgetta Tempel, Petitioners, v. Commissioner of Internal Revenue, Respondent*  
136 T.C. No. 15, April 5, 2011

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. However, the Court also ruled that the petitioners had no basis in the tax credits. Further Tax Court determined that the gain on the sales should be treated as short-term capital gains because the sales of the credits occurred just days after their acquisition.

### TAKEAWAY

Following a well-established precedent, 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

On December 17, 2004, George and Georgetta Tempel (“Mr. Tempel” and “Mrs. Tempel,” respectively; “Petitioners” or the “Tempels,” collectively) donated a qualified conservation easement of land in Colorado to a qualified organization. As a result of the donation, the Petitioners received \$260,000 in state income tax credits. In connection with the donation, the Tempels paid \$11,574.74 in expenses, primarily professional fees.

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.

Five days after their donation of the conservation easement, the Tempels sold \$40,500 worth of credits for net proceeds of \$30,375. On December 31, 2004, the Petitioners sold another \$69,500 of state income tax credits for net proceeds of \$52,125. On the same day, the Tempels gave away another \$10,000 of their credits.

On their 2004 federal income tax return, the Petitioners reported \$82,500 in short term capital gains associated with the sale of the credits and a basis in the credits of \$4,897. Their basis was determined by allocating the \$11,574.74 in expenses associated with the donation to the proportion of credits sold (i.e., \$110,000 credits sold / \$260,000 total credits x \$11,574.74). (In their cross-motion for partial summary judgment, the Petitioners asserted that their short-term capital gains should have been reported as long-term capital gains, and they believed they were entitled to reduce such gains by the allocable basis.)

The IRS disagreed with the Petitioners’ determination of tax liability and determined that the Tempels owed additional tax and penalties. In particular, the Respondent concluded that the Petitioners lacked basis in their tax credits and that the gains should be taxed as ordinary income rather than as capital gains.

## DISCUSSION

The Tempels' 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 Respondent asserted that the Court should follow the logic of [Gladden v. Commissioner \(112 T.C. 209, 1999\)](#). The Court rejected the IRS' assertion because the Tax Court could not conclude that tax credits are contract rights from the governmental entity that issues the credit.

Additionally, the Court determined that tax credits are not accessions to wealth and cannot be taxed as ordinary income.

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 Tempels 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 Petitioners were correct in their initial filing that their gain on the sale of the state income tax credit was short-term. The Tax Court found that the Tempels 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 the Tempels bought the land which was donated in the conservation easement.

## CONCLUSION

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. 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.

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