

In The Matter of the Petition of "M"

for a Declaratory Ruling

DOC #4252, Effective March 24, 1987

DECLARATORY RULING

Pursuant to RSA 541-A:1, I-b; 541-A:2, I (c); and Rev PART 209 of the New Hampshire Code of Administrative Rules, "M" has petitioned the Department of Revenue Administration for a declaratory ruling stating that:

The New Hampshire Business Profits Tax (RSA 77-A) does not apply to the sale of land and building used exclusively for residential purposes, even though both land and building were owned and maintained by a taxable, corporate business organization.

The Petitioner presents the following facts:

1. A parcel of land with two buildings was acquired by "A" personally in 19-- . One building was a residence, the other, known as operated as a business.
2. The business was conducted as a proprietorship in 19--.
3. All land and both buildings were transferred by "A" in 19-- to a newly formed corporation in a tax-free exchange. Stock was held by "A" and --- two sons. In the time period for which this ruling request is made the stock is wholly-owned by the two sons.
4. The business was seasonally run both in proprietorship and corporate form. The residence was seasonally occupied.
5. A less than formal agreement, but clearly a binding, perhaps oral "understanding" existed between "A" and "M" whereby the corporation permitted "A" to occupy the "residence building" while she seasonally attended to the business of ---
6. A four-unit apartment building has been built on the corporate land and rented since construction.
7. Taxpayer's Petition states that no tax benefit has been derived relative to the "residence." No depreciation of the "residence" building has been made.
8. Local real estate taxes were paid by "M" as well as some general maintenance and repairs. When these repairs amounted to capital improvements, they were not depreciated. These expenditures were considered compensation for services by Petitioner, although they have never been reported as income by the recipient.
9. The Town of --- , N.H. has recognized the "residence" as non-commercial, residential property and the other buildings as commercial. It has taxed them accordingly. No indication as to how the town segments the current single lot of land between residential and commercial purposes is apparent from the petition. Some such boundary is assumed evidenceable.
10. The land and "residence" building has been represented by the taxpayer to both the State of New Hampshire and the United States as "land" on the corporate balance sheets.

I. Ruling : The Department of Revenue Administration, based on the facts presented, and limited only to these facts rules that sale of the land and building characterized as "residence" by the taxpayer is the sale of a business asset within the meaning of RSA 77-A.

II. Taxation Theory Underlying RSA 77-A .

The business profits tax of RSA 77-A is constitutionally premised on both an income tax and a property tax analysis. As a property tax it is perceived as a tax on net income as the property produced by business activity conducted within, or within and without New Hampshire. Net income measures the property. This argument is sourced in the 1903 amendment to the New Hampshire Constitution, Part II, Art. 6 where the phrase "and other classes of property" was added to the designation of taxable polls and estates. See: Opinion of the Justices, 123 NH 296 (1983), Opinion of the Justices, 110 NH 117 (1971), Opinion of the Justices, 95 NH 537 (1949) as well as the Supplementary Brief of Jeremy R. Waldron, N.H. Attorney General in Arthur J. Connor v. State No. 2039 (1925). The income tax argument argues that taxable estate includes income before the 1903 amendments. Opinion of the Justices, 77 NH 611 (1915). It cites the early tax acts of April 12, 1770; January 2, 1772; July 2, 1776; and June 12, 1784, each of which contained language that, "every person may be compelled to pay in proportion to his income." See also Robinson's History of New Hampshire Taxation.

III. The Measure of Property, or Calculation of Net Income.

For corporate business organizations the calculation of net income or the measure of property taxed, that is the tax base, starts with the federal line 28 of form 1120 which is labeled "taxable income before net operating loss and special deduction." RSA 77-A:1, III (a) reads in full;

In the case of a corporation, except "S" corporations, or any other business organization required to make and file a United States corporation income tax return, or in the case of a corporation which does not make and file a separate United States corporation income tax return for itself because it is a member of an affiliated group pursuant to the provisions of chapter 6 of the United States Internal Revenue Code (1954) as amended, the amount shown or which would be shown as taxable income before net operating loss deduction and special deductions on such return.

It has been the long standing practice and publicly acknowledged policy of the Department of Revenue Administration to read this language as clearly directing the taxpayer corporation to begin his calculation of taxable business profits with the number properly determined as "taxable income before net operating loss and special deductions." This amount is adjusted by the allocation provisions of RSA 77-A:3 and the deductions of RSA 77-A:4. Our earliest statement of this position was recorded in the brief filed by Atty. Charles G. Cleveland for one of the acknowledged authors of the business profits tax, the then Attorney General Warren B. Rudman in 1973. The case was Shangri-La, Inc. v. State of New Hampshire, 113 NH 440, 309 A2d 285 (1973). At pages two and three of our brief we argued as follows:

ARGUMENT

I. LEGISLATURE INTENDED THAT GAIN FROM THE SALE OF BUSINESS PROPERTY REALIZED ON OR AFTER JANUARY 1, 1970, SHOULD BE COMPUTED UPON A BASIS IDENTICAL TO THAT REPORTED BY THE TAXPAYER ON ITS FEDERAL INCOME TAX RETURN FOR THE TAXABLE YEAR IN WHICH THE SALE OCCURRED.

RSA 77-A:1 (III) (a) provides the definition of Gross Business Profits applicable to the petitioner as follows:

In the case of a corporation or any other business organization required to make and file a United States corporation income tax return, the amount shown as "taxable income before net operating loss deduction and special deductions" on such return, or in the case of a corporation which elects

treatment as a small business corporation under the United States Internal Revenue Code (1954) as amended, the amount shown as "taxable income" on its United States small business corporation income tax return;

This definition does not attempt merely to use terms of art familiar in the federal income tax context such as net capital gains, or ordinary income. Rather, this definition makes specific and unambiguous reference to an amount shown on the taxpayer's federal income tax return at a certain line item, and identifies that item by quotation of the label given that item on the federal return. In this case, the federal return in question was a form 1120S, petitioner being a small business corporation within the meaning of the Internal Revenue Code, the amount shown as "taxable income" on form 1120S is line 28, and that amount on petitioner's return for the year in question is \$_____.

We simply do not perceive any room for dispute about what the Legislature intended in this definition. The Legislature said in effect "that is the amount we want to use, however, it may be computed under federal code and regulations". If a basis other than that used to compute gain for federal income purposes is used to compute gain for New Hampshire Business Profits Tax purposes, then, ipso facto, the amount so arrived at will not be "the amount shown as 'taxable income' on [the federal] return" as required by RSA 77-A:1 (III) (a).

We submit that to achieve the result desired by the petitioner, this Court would necessarily have to rewrite the law, not merely interpret it. The court framed this issue in Shangri-La as,

This appeal questions the tax commission's determination that for the purpose of the Business Profits Tax (RSA ch. 77-A) the taxpayer's gain on the sale of its business property should be computed on the basis of its federal income tax return (cost less accumulated depreciation) rather than the fair market value on the effective date of the tax statute (January 1, 1979). (113 NH at 440-441)

The court ruled in favor of the department, holding that the gain from the sale of assets by Shangri-La Inc. was taxable because that gain appeared on a properly filed form 1120 with the Internal Revenue Service.

This position has been consistently adopted by the New Hampshire Supreme Court in The Estate of Kennett v. State, 115 NH 50; 333 A2d 452 (1975); Concord Investment Corporation v. New Hampshire Tax Commissioner 114 NH 105, 316 A2d 192 (1974); New Jersey Machine of New Hampshire Inc. v. State Department of Revenue Administration, 117 NH 262, 372 A2d 604 (1977); Johns-Manville Products Corp. v. Commissioner of Revenue Administration, 115 NH 428, 343 A2d 221 (1975); Jacobs v. Price, 125 N.H. 196, 485 A2d 282 (1984) and Bradley Real Estate Investment Trust v. Department of Revenue Administration, 128 NH (1986). The Department of Revenue Administration adheres to this consistently adopted interpretation. If the amount will be "shown" on a properly filed federal 1120, then that amount is presumptively includible in the New Hampshire tax base. It is ipso facto part of the measure of property, or calculation of net income for purposes of the business profits tax.

IV. Application.

"M" advances no argument which would convince the Department that the sale of the "residence" building would not be includible on a properly filed federal form 1120. Title to the land and building is held by the corporation. It will be or has been sold to a third party not by a shareholder, but by the corporation. Taxes, as well as most repair and maintenance of the "residence," were paid from corporate accounts, because "A" was accorded unrestricted use of the building by agreement or understanding as a significant vehicle for compensating --- for valued services rendered to the corporation. The fact that allowable depreciation was not taken by the corporation is not material. Why such a decision was made by "M" when the sale of the asset in question must be reported on form 1120 net of allowable depreciation is not a question for this department to ponder. All the facts presented indicate that in lieu of cash compensation, "A" preferred to be compensated and "M" agreed to compensate ---, in kind for --- services. The corporation maintained for this purpose a "residence."

The Department has no authority to restructure for the taxpayer at this date the compensation structure it has consciously erected and maintained as a corporate asset.

Everett V. Taylor, Commissioner