

**SANITIZED DEC. 04-274 FN – BY GEORGE V. PIPER – SUBMITTED FOR
DECISION ON BRIEFS 10/24/04 – ISSUED 10/28/04**

SYNOPSIS

BUSINESS FRANCHISE TAX -- UNRECOGNIZED CAPITAL GAIN NOT TO BE REFLECTED ON PETITIONER'S CORPORATE FORM 1120 – Petitioner who engaged in a like-kind exchange pursuant to Section 1031 of the Internal Revenue Code was not required to reflect same in either the asset or stockholders' equity section of Schedule L of its corporate form 1120.

BUSINESS FRANCHISE TAX -- UNRECOGNIZED GAIN NOT TO BE INCLUDED – Unrecognized amount of capital gain realized from a like-kind exchange pursuant to Section 1031 of the Internal Revenue Code is not to be included as part of taxable capital for purposes of the West Virginia business franchise tax statute.

FINAL DECISION

The Field Auditing Division of the West Virginia State Tax Commissioner's Office conducted an audit of the books and records of the Petitioner. Thereafter, on February 19, 2004, the Director of this Division of the Commissioner's Office issued a business franchise tax assessment against the Petitioner. The assessment was for the period of May 1, 2000 through April 30, 2003, for tax, interest, through February 29, 2004, for a total assessed liability. Written notice of this assessment was served on the Petitioner.

Thereafter, by mail postmarked April 14, 2004, the Petitioner timely filed with this tribunal, the West Virginia Office of Tax Appeals, a petition for reassessment. *See* W. Va. Code § 11-10A-8(1) [2002].

Subsequently, notice of a hearing on the petition was sent to the Petitioner and a hearing was held in accordance with the provisions of W. Va. Code § 11-10A-10 [2002] and 121 C.S.R. 1, § 61.3.3 (Apr. 20, 2003).

FINDINGS OF FACT

1. The Petitioner was incorporated under the laws of a surrounding state on April 25, 1941, and during the years in question, was engaged in business in that state and West Virginia.
2. The Petitioner files its income tax and business franchise tax returns on a fiscal year basis beginning on May 1, and ending on April 30.
3. On February 28, 1999, the Petitioner sold certain property it owned in the surrounding state for a gain, but, pursuant to the like-kind exchange provisions of Internal Revenue Code § 1031, deferred recognition of the gain for income tax purposes.
4. On June 30, 1999, to complete its like-kind exchange, the Petitioner reinvested the proceeds of the sale of the surrounding state property into the acquisition of certain improved property in West Virginia.
5. On Schedule L of its federal income tax return (Form 1120) for the year ended April 30, 1999, the Petitioner entered the amount of the unrecognized gain as “Trade notes and accounts receivable” in the asset section and as “Additional paid-in-capital” in the Stockholders’ Equity section.
6. On Schedule L of its federal income tax returns (Form 1120) for the four (4) tax years ended April 30, 2000, 2001, 2002 and 2003, the Petitioner included the amount of

the unrecognized gain on the lines labeled “Buildings and other depreciable assets” and “Land” in the asset section and on the line labeled “Additional paid-in-capital” in the Stockholders’ Equity section.

DISCUSSION

The first issue is whether an unrecognized capital gain resulting from a like-kind exchange pursuant to section 1031 of the Internal Revenue Code is to be reflected in either the asset or stockholder’s equity sections of the Schedule L balance sheet included with Petitioner’s corporate form 1120.

Although this tribunal does not as a rule make any pronouncements as to what should or should not be reported for federal income tax purposes, an exception is being made in this case because, if the unrecognized income from the like-kind exchange is not required to be reflected on Petitioner’s corporate form 1120, it stands to reason that the same would not have to be included for West Virginia business franchise tax purposes.

When a corporate taxpayer engages in a like-kind exchange of tangible, non-inventory capital assets pursuant to Section 1031 of the Internal Revenue Code of 1986, as amended (IRC), without receiving any cash consideration, it does not recognize, for federal income tax purposes, any gain even though the fair market value of the replacement asset exceeds the cost basis of the relinquished asset. IRC § 1031(d). As a result, any recognition of the gain for federal income tax purposes is effectively deferred until such time as the replacement asset may be liquidated for more than that substituted basis.

This tribunal cannot find any authority for recognizing the unrecognized gain on the corporation's balance sheet contained in Schedule L of its Form 1120 return. Rather, the instructions for preparing that Schedule L balance sheet indicate that "[e]ntries on this page should agree with amounts shown elsewhere on the return." IRS Publication 542 "Corporations," p. 18. Because no amounts are to be reflected on the return indicating federal income tax liability with respect to the unrecognized gain, no amounts should therefore be reflected on the Schedule L balance sheet.

As a result of substituting the income tax basis of the relinquished asset for the income tax basis of the replacement asset, no change in the amounts of the entries in the asset section of the Schedule L as a result of the like-kind exchange is appropriate. Likewise, under the double-entry organizing principle controlling the completion of the balance sheet, neither is any change in the entries in the liability or stockholders' equity sections of the Schedule L appropriate with respect to the unrecognized gain resulting from such an exchange.

Accordingly, it is **DETERMINED** that there is no federal requirement to reflect unrecognized capital gains resulting from like-kind exclusions in either the asset or stockholder's equity section of Schedule L of Petitioner's corporate form 1120.

The second issue, which follows, is whether the amount of capital gain that is not recognized by a corporation for federal income tax purposes, as a result of its engaging in a like-kind exchange pursuant to section 1031 of the Internal Revenue Code must still be included in Petitioner's capital for purposes of the West Virginia business franchise tax.

The basis of the business franchise tax imposed on a corporation doing business in West Virginia is its “Capital” as defined in the governing statute. W. Va. Code §§ 11-23-4, 11-23-6.

Specifically, the law states in pertinent part:

(2) Capital. – The term ‘capital’ of a taxpayer shall mean:

(A) Corporations. – In the case of a corporation . . . the average of the beginning and ending year balances of the sum of the following entries from Schedule L of the Federal Form 1120, *prepared following generally accepted accounting principles* and as filed by the taxpayer with the Internal Revenue Service for the taxable year:

- (i) The value of all common stock and preferred stock of the taxpayer,
- (ii) The amount of paid-in or capital surplus;
- (iii) The amount of retained earnings, appropriated and unappropriated; and
- (iv) Less the cost of treasury stock.

W. Va. Code § 11-23-3(b)(1). [Emphasis added]

According to generally accepted accounting principles (GAAP), a corporation’s acquisition of assets through an exchange of other assets does not effect a change in the equity section of the corporation’s balance sheet. See excerpt from Financial Accounting Standards Board (FASB), “Statement of Financial Accounting Concepts No. 6,” paragraph 65.A., (Attached to Petitioner’s Brief Attachment A.)

Moreover, consistent with the substituted basis rule applicable to the federal income tax treatment of replacement assets acquired in a like-kind exchange, GAAP also dictates that the amount stated for an acquired tangible capital asset should be its acquisition cost. See excerpt from FASB “Statement of Financial Accounting Concepts No. 5,” paragraph 67.a. (Attached as Petitioner’s Brief Attachment B.) GAAP also provides that, once acquired, the amount shown for such assets can be changed to reflect

current values only if they are “expected to be sold at *prices lower* than previous carrying amounts.” Id. at paragraph 67.c. (Emphasis added) Thus, under GAAP, in an exchange of capital assets the acquisition cost of the replacement asset is the acquisition cost of either.

Upon applying the foregoing legal principles to the facts of the present matter, it is clear that unrecognized gain resulting from the Petitioner’s like-kind exchange may not properly serve as the basis for any business franchise tax liability. That is because, under both federal income tax reporting requirements and GAAP, in a corporation’s exchange of capital assets, the original acquisition cost – not current value – of the relinquished property becomes the amount stated as the value of the replacement property. Any appreciation of that original acquisition cost remains unrecognized in stating the amount of the corporation’s assets. Moreover, absent any appropriate change in the amounts stated for such assets in the asset section of that entity’s balance sheet, this is also not an occasion to reflect any unrecognized appreciation in the balancing liability/owners’ equity section of the same entity’s balance sheet.

CONCLUSIONS OF LAW

Based upon all of the above it is **HELD** that:

1. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon a petitioner-taxpayer to show that the

assessment is incorrect and contrary to law, in whole or in part. *See* W. Va. Code § 11-10A-10(e) [2002] 121 C.S.R. 1, § 63.1 (Apr. 20, 2003).

2. The Petitioner-taxpayer in this matter has carried the burden of proof with respect to the issue of whether unrecognized gain from a like-kind pursuant to Section 1031 of the Internal Revenue Code should have been included in taxable capital for purposes of the West Virginia business franchise tax.

DISPOSITION

WHEREFORE, it is the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that the business franchise tax assessment issued against the Petitioner for the period of May 1, 2000 through April 30, 2003, for tax, interest, and no additions to tax, should be and is hereby **VACATED**, and the Petitioner owes no further business franchise tax liability for the period in question.