



Iowa General Assembly

2015 Legal Updates

Legislative Services Agency – Legal Services Division

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Purpose. *Legal update briefings are prepared by the nonpartisan Legal Services Division of the Legislative Services Agency. A legal update briefing is intended to inform legislators, legislative staff, and other persons interested in legislative matters of recent court decisions, Attorney General Opinions, regulatory actions, federal actions, and other occurrences of a legal nature that may be pertinent to the General Assembly's consideration of a topic. Although a briefing may identify issues for consideration by the General Assembly, a briefing should not be interpreted as advocating any particular course of action.*

CAPITAL GAIN DEDUCTION FROM INDIVIDUAL INCOME TAX

LEGAL UPDATE—CAPITAL GAIN DEDUCTION FROM INDIVIDUAL INCOME TAX

Filed by the Iowa Court of Appeals

September 10, 2015

George M. Lance and Phyllis J. Lance v. Iowa State Board of Tax Review

No. 14-1144

[http://www.iowacourts.gov/About the Courts/Court of Appeals/Court of Appeals Opinions/Recent Opinions/20150910/14-1144.pdf](http://www.iowacourts.gov/About%20the%20Courts/Court%20of%20Appeals/Court%20of%20Appeals%20Opinions/Recent%20Opinions/20150910/14-1144.pdf)

Background Facts and Prior Proceedings. George and Phyllis Lance (taxpayers) bought a rental house in 1981 that they personally managed until 1994. In that year, the taxpayers contracted with a property management company for the day-to-day management of the property, but the taxpayers continued to perform some activities such as pay bills, perform some maintenance, inspect the property, oversee major repairs, interface with city inspectors, and approve major expenditures. The taxpayers kept records of the bills paid but did not keep contemporaneous calendar, time, or activity logs. In 2005, the taxpayers sold the property and deducted the resulting capital gains from their Iowa individual income tax pursuant to Iowa Code section 422.7(21).

Iowa Code section 422.7(21) provides, in relevant part, that capital gains from the sale of real property used in a business may be deducted if the taxpayer: 1) held the property for a minimum of 10 years and 2) materially participated for 10 years in the business. “Material participation” is defined under the Internal Revenue Code (IRC). The Department of Revenue (Department), has through administrative rule, interpreted material participation to mean that the taxpayer must materially participate in the business for the 10-year period immediately preceding the sale.

The Department disallowed the capital gains deduction because the taxpayers did not materially participate in the business of managing the rental house for the 10-year period immediately preceding the sale. Upon protest, the taxpayers argued that the Department’s administrative rule interpretation of Iowa Code section 422.7(21) is contrary to statute, but also argued that they nonetheless satisfied that rule. An administrative law judge issued a proposed decision in favor of the taxpayers, but the Director of Revenue disagreed and reversed. The taxpayers appealed the Director’s decision to the State Board of Tax Review and subsequently to the district court, both of which affirmed the decision of the Director of Revenue. The taxpayers filed this appeal.

Issues. Whether the Department’s administrative rule correctly interpreted the 10-year material participation requirement of Iowa Code section 422.7(21), and whether the taxpayers satisfied that requirement.

Analysis. The Iowa Court of Appeals (Court) first considered the statutory interpretation question. The taxpayers argued that the statutory language “materially participated for 10 years” is clear and unambiguous and simply requires a taxpayer to materially participate in the business for any 10-year period coinciding with ownership, not necessarily the 10-year period immediately preceding the sale of the property as required by the Department’s administrative rule. Thus, the Department’s interpretation should not be entitled to any deference. The Department argued that the language is not clear and unambiguous and that it has been vested with authority to interpret the statute and thus

should be afforded deference in its interpretation.

The Court acknowledged that the Iowa Supreme Court has on several occasions held that Iowa Code section 422.68 vests the Department with the authority to interpret Iowa Code chapter 422 (income and franchise taxes) and, as a result, the Department's interpretation will be given deference and only reversed if it is "irrational, illogical, or wholly unjustifiable." The Court accepted the Department's interpretation of the statute for several reasons. First, the statute was sufficiently ambiguous and did not, on its face, preclude the Department's interpretation. Second, the Department's interpretation is in harmony with the IRC definition of "material participation." Third, tax exemptions are historically strictly construed against the taxpayer and liberally in favor of the Department. Fourth, the Legislature has acquiesced to the Department's interpretation of the statute because no countermanding legislative action has been taken since the administrative rule was adopted in 1990.

Having determined that the Department's administrative rule interpretation was valid, the Court then quickly disposed of the material participation question. The Department had previously concluded that the taxpayers' evidence of the number of hours worked over the last 10 years contained large revisions and guestimates, and therefore was not credible or a reasonable means to prove material participation under the IRC. The Department had also determined that most of the taxpayers' activities over the last 10 years were "investor-type activities" that do not support material participation under the IRC. The Court held that the Department's findings were supported by substantial evidence.

Holding. The Department's administrative rule interpreting the capital gains deduction for real property used in a business in Iowa Code section 422.7(21) to require material participation in the business for the 10-year period immediately preceding the sale is valid, and in this case the taxpayer's activities did not satisfy that requirement.

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