

Commission's interpretation results in an inequitable treatment for nonresidents. The taxpayers stated an Idaho legislator was going to introduce legislation in the 2006 legislative session that would clarify the application of the capital gains deduction for nonresidents, leaving no basis in the law for the adjustment.

The Bureau referred the matter for administrative review. The Tax Commission acknowledged the taxpayers' protest and their request to postpone any further action until after the 2006 legislative session. The 2006 legislative session ended with nothing introduced to change the Idaho capital gains deduction statute. The taxpayers had nothing further to provide, so the Tax Commission issues this decision on the matter.

The taxpayers were residents of [Redacted] in 2002. The taxpayers were the sole shareholders of an Idaho S-corporation. The S-corporation sold its major asset (a commercial building) in 2002. The S-corporation also dissolved during that year. The taxpayers realized a gain on the sale of the commercial building and a loss on the liquidation of the S-corporation. On the taxpayers' Idaho individual income tax return, the taxpayers reported the income from the S-corporation and the gain on the sale of the commercial building. On the taxpayers' federal income tax return, the taxpayers reported, in addition to the income and gain reported on the Idaho return, other income and the loss on the liquidation of the S-corporation.

Idaho Code section 63-3022H provides for a deduction on the gain realized on a qualified Idaho capital gain. The property sold by the S-corporation was qualified Idaho capital gain property. Idaho Code section 63-3022H only allows the deduction to individuals (Idaho Code section 63-3022H(1)) and, since S-corporations are pass-through entities, the gain and its character flow through to the taxpayers. The taxpayers computed the capital gain deduction;

however, they did not take into account the limitations set forth in Idaho Code section 63-3022H(2).

Subsection (2) stated:

The deduction provided in this section is limited to the amount of the capital gain net income from all property included in taxable income. Gains treated as ordinary income by the Internal Revenue Code do not qualify for the deduction allowed in this section. The deduction otherwise allowable under this section shall be reduced by the amount of any federal capital gains deduction relating to such property, but not below zero.

The Bureau adjusted the taxpayers' 2002 return because they reported capital gain net income on their federal return in the amount of \$29,474. The capital gain deduction the taxpayers claimed on their Idaho return was \$263,388. The Bureau's adjustment limited the capital gain deduction to the capital gain net income reported on the taxpayers' federal income tax return (Idaho Code section 63-3022H(2)).

The taxpayers argued the Tax Commission is interpreting the law in a manner that was never intended by the Idaho legislature. They stated the law was drafted with Idaho residents in mind and resulted in unintended, inequitable results for some nonresidents. The taxpayers pointed to a change in the wording of section 63-3022H from 2001 to 2002 as an indication that the law was not intended to be applied the same for residents and nonresidents. The wording change removed the word federal from the phrase federal taxable income. The taxpayers argued that residents begin with federal adjusted gross income so it is perfectly appropriate to base a deduction on what is includable in federal taxable income. However, for nonresidents, their income is solely dependent on their Idaho source income and has nothing to do with federal taxable income. The taxpayers stated a nonresident individual could have zero federal taxable income and have a large Idaho taxable income, but, for Idaho residents, their Idaho taxable

income is the same as their federal taxable income. The taxpayers argued that the capital gain deduction for a nonresident being limited to federal capital gain net income makes no sense and has no relationship to what is includable in Idaho income.

The taxpayers believe the Idaho statute is inequitable because it has unintended results for some nonresidents. Whether or not the Idaho statute is inequitable, the statute is not unclear as to its provisions and limitations. For a deduction to be allowed, section 63-3022H requires all individuals to have capital gain net income included in the determination of taxable income and to have qualified property. The statute does not distinguish between residents and nonresidents. In this case, the dissolution and liquidation of the taxpayers' S-corporation shortly after the sale of the Idaho property created a capital loss for the taxpayers. This loss reduced the taxpayers' capital gain net income thereby lowering the limitation for purposes of determining the Idaho capital gains deduction. Even though the capital loss is only reported on the taxpayers' federal return, it is part of the computation of capital gain net income and therefore becomes a factor in the limitation for the Idaho capital gains deduction.

The taxpayers argued the change in wording in the statute gives an indication that nonresident taxpayers should only be limited by the income included in Idaho taxable income. However, the change referred to was to eliminate redundancies in the Idaho Code. Idaho Code section 63-3011B defines the term "taxable income" as used in the Idaho Code. It states that taxable income means federal taxable income as determined in the Internal Revenue Code. Therefore, removing the word "federal" from section 63-3022H(2) does not change its meaning from federal taxable income to Idaho taxable income. Both residents and nonresidents are still limited to the capital gain net income included in their federal taxable income.

The Tax Commission's review of this matter finds the statute clear and unambiguous. "In such case our duty is clear. We must follow the law as written. If it is socially or economically unsound, the power to correct it is legislative, not judicial." John Hancock Mutual Life Ins. Co. v. Neil, 79 Idaho 385, 319 P.2d 195 (1957). See also Idaho State Tax Comm'n v. Stang, 135 Idaho 800, 803, 25 P.3d 113, 116 (2001), and Canty v. Idaho State Tax Comm'n, 138 Idaho 178, 59 P.3d 983 (2002). Therefore, the Tax Commission upholds the Bureau's adjustment.

The Bureau added interest to the taxpayers' tax deficiency. The Tax Commission reviewed the addition and found it appropriate and in accordance with Idaho Code section 63-3045.

WHEREFORE, the Notice of Deficiency Determination dated March 10, 2005, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2002	\$18,247	\$3,987	\$22,234

Interest is computed to January 15, 2007.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of taxpayers' right to appeal this decision is enclosed.

DATED this ____ day of _____, 2006.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE BY MAIL

I hereby certify that I have on this ____ day of _____, 2006, served a copy of the within and foregoing DECISION by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]
[Redacted]
[Redacted]

Receipt No.
