

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 22661
[Redacted],)	
)	
Petitioners.)	DECISION
_____)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated January 6, 2010, asserting an additional liability for Idaho income tax and interest in the total amount of \$996 for 2006.

The only issue involved in this docket is the amount of the petitioners' capital gain that is qualified for the Idaho capital gains deduction. The auditor determined that the petitioners' non-recaptured net IRC § 1231 losses caused some of the petitioners' gains to be treated as ordinary income pursuant to Internal Revenue Code IRC §1231(c) which stated:

Recapture of net ordinary losses. (1) In general. The net section 1231 gain for any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses.

The auditor reduced the amount of the gain qualifying for the Idaho capital gains deduction by the entire amount of the non-recaptured net IRC § 1231 losses. The petitioners contend that the recharacterization of the income for [Redacted] purposes should not be determinative since the IRC § 1231 losses were from the disposition of property, a gain from which would not have qualified for the Idaho capital gain deduction. The petitioners base their argument on Idaho Administrative Income Tax Rule 170.04.

Idaho Code § 63-3022H stated, in pertinent part:

Deduction of capital gains. (1) If an individual taxpayer reports capital gain net income in determining taxable income, eighty percent (80%) in taxable year 2001 and sixty percent (60%) in taxable years thereafter of the capital gain net income

from the sale or exchange of qualified property shall be a deduction in determining Idaho taxable income.

(2) 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. (Emphasis added.)

Idaho's Income Tax Administrative Rule 170 provided, in pertinent part:

03. Ordinary Income Limitation. The Idaho capital gains deduction may not include any gains treated as ordinary income pursuant to the Internal Revenue Code. For example, any gain from the sale, exchange, or involuntary conversion of certain depreciable property treated as ordinary income pursuant to Section 1245, Internal Revenue Code, may not be included when computing the Idaho capital gains deduction. (4-11-06)

04. Losses From Nonqualified Property. Losses from property not qualifying for the Idaho capital gains deduction may not be netted against gains from property qualifying for the Idaho capital gains deduction before the amount of the deduction is determined. (4-11-06)

The amount of the gain which is to be recharacterized due to the non-recaptured net IRC § 1231 losses is \$17,986. The amount of the gain which could be subject to recharacterization is \$116,906, of which \$7,970 is gain not qualifying for the Idaho capital gains deduction. The remaining \$108,936 of gain is from the disposition of qualifying property.

The proper method of allocating the recharacterization to the qualifying and nonqualifying gains is the only question. It appears that the petitioners' method is clearly wrong, at least in part in that they have claimed the capital gains deduction on gains which were, for federal purposes, recharacterized as ordinary income. To find that the petitioners' method was correct would be to find that the rule¹ could nullify a portion of the Idaho Code. This produces

¹ Administrative Income Tax Rule 170.04

an ambiguity in the law. Such a situation was addressed by the Idaho Supreme Court, in part, as follows:

When construing the provisions of the Idaho Income Tax Code, however, we must enforce the law as written. Potlatch Corp. v. Idaho State Tax Comm'n, 128 Idaho 387, 913 P.2d 1157 (1996). If there is any ambiguity in the law concerning tax deductions, the law is to be construed strongly against the taxpayer. *Id.* This Court has no authority to rewrite the tax code. Bogner v. State Dep't of Revenue and Taxation, 107 Idaho 854, 693 P.2d 1056 (1984). Any exemption from taxation must be created or conferred in clear and plain language and cannot be made out by inference or implication. Herndon v. West, 87 Idaho 335, 393 P.2d 35 (1964). This Court does not have the authority to create deductions, exemptions, or tax credits. If the provisions of the tax code are socially or economically unsound, the power to correct it is legislative, not judicial. *Id.*

Idaho State Tax Commission v. Stang, 135 Idaho 800, 802-803 (2001).

It appears clear that Rule 170.04 did not contemplate whether losses from nonqualifying property from a prior year (due to the function of Internal Revenue Code net IRC § 1231(c)) could effectively reduce the gain eligible for the Idaho capital gains deduction from qualifying property in the current year. In any case, the gain or loss from the transaction from the prior year is not recognized in the current year. The only effect is that there may be a recharacterization of the gains from capital gain to ordinary income in the current year. Idaho Code § 63-3022H clearly states that “[g]ains treated as ordinary income by the Internal Revenue Code do not qualify for the deduction allowed in this section.”

So the question remains as to how much the gain from eligible property should be reduced due to the recharacterization of some of the gain to ordinary income. The amount subject to recharacterization is \$116,906. Of this amount, \$108,936, or 93.183 percent, is from qualifying property. Therefore, the Commission holds that 93.183 percent of the \$17,986 or \$16,760 is recharacterized as ordinary income thereby reducing the amount eligible for the Idaho capital gains deduction.

WHEREFORE, the Notice of Deficiency Determination dated January 6, 2010, is hereby MODIFIED, and as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax and interest (computed to November 30, 2010):

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2006	\$787	\$170	\$957

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

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

DATED this _____ day of _____ 2010.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2010, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.
