02-0902
INCOME TAX
TAX YEARS: 1998, 1999
SIGNED: 11-25-2003
COMMISSIONERS: P. HENDRICKSON, R. JOHNSON, P. DEPAULIS, M. JOHNSON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2,	)	**FINDINGS OF FACT**,
	)	**CONCLUSIONS OF LAW,**
Petitioners,	)	**AND FINAL DECISION**
	)	
v.	)	Appeal No. 02-0902
	)	Account No. #####
AUDITING DIVISION OF THE	)	
UTAH STATE TAX COMMISSION,	)	Tax Type: Income Tax
	)	Tax Years: 1998, 1999
Respondent.	)	Judge: Davis

Presiding:
G. Blaine Davis, Administrative Law Judge

Appearances:

For Petitioner:	PETITIONER REP.
	PETITIONER 1
For Respondent:	RESPONDENT REP. 1, Assistant Attorney General
	RESPONDENT REP. 2, from the Auditing Division
	RESPONDENT REP. 3, from the Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on June 25, 2003. At the conclusion of the hearing, the parties requested time in which to file post hearing briefs. Respondent was given fifteen (15) days in which to file such a brief, and Petitioner was given ten (10) days thereafter in which to file a brief if he so desired. Respondent filed a post hearing brief on July 11, 2003, but Petitioner has not filed such a brief. Based upon the evidence and

testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. On their 1998 and 1999 Income Tax Returns, Petitioners took a retirement income deduction for amounts received from their individual retirement account (IRA).

2. The IRA of Petitioners was created when PETITIONER 1 was laid off from COMPANY A in August of 1992, and he rolled his 401(k) plan into an individual retirement account. He thereafter commenced drawing on that account in 1993.

3. PETITIONER 1 was born on January 17, 1941, so for the years in question, 1998 and 1999, he turned 57 and 58 years of age.

4. The 1099R forms received on the IRA distribution were coded with a "2" for "early distributions" instead of a "7" for "normal distributions".

5. The question in this matter is whether the retirement income deductions taken by Petitioners for the amounts received from the IRA of PETITIONER 1 during the years at issue were legally permissible under the provisions of Utah Code Ann. §59-10-114(2).

APPLICABLE LAW

Utah Code Ann. §59-10-114(2) provides in relevant part:

> (2) There shall be subtracted from federal taxable income of a resident or non-resident individual;
>
> . . . .
>
> (d) amounts received by taxpayers under age 65 as retirement income which, for purposes of this section, means pensions and annuities, paid from an annuity contract purchased by an employer under a plan which meets the requirements of section 404(a)(2), Internal Revenue Code, or purchased by an

employee under a plan which meets the requirements of section 408, Internal Revenue Code, or paid by the United States, a state, or political subdivision thereof, or the District of Columbia, to the employee involved or the surviving spouse;

Utah Administrative Code Rule R865-9I-38, provides in relevant part:

A. Amounts received by taxpayers from pension or annuity plans described in Section 59-10-114 are not retirement income for purposes of that section if:

1. The amounts received are subject to the penalty or additional tax imposed by I.R.C. §§72(q) and (t); or

. . . .

3. The amounts received are due to termination of employment before reaching a normal retirement age as established under the qualifying plan.

Section 72(t), Internal Revenue Code, provides in relevant part:

(t) 10-percent additional tax on early distributions from qualified retirement plans

(1) Imposition of additional tax

If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Except as provided in paragraphs (3) and (4), paragraph (1) shall not apply to any of the following distributions:

(A) In general

Distributions which are –

(i) made on or after the date on which the employee attains age 592,

. . . .

(iv) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary,

. . . .

(4) Change in substantially equal payments

(A) In general

> If –
>
> (i) paragraph (1) does not apply to a distribution by reason of paragraph (2)(A)(iv), and
>
> (ii) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability) –
>
> (I) before the close of the 5-year period beginning with the date of the first payment and after the employee attains age 592, or
>
> (II) before the employee attains age 592, the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(a)(iv) would have been imposed, plus interest for the deferral period.

Paragraph 2179 from the 2002 CCH US Master Tax Guide states:

> **2179 Early Distributions**. Distributions from a traditional IRA to a participant before the individual has reached age 592 are generally subject to the same 10% penalty that applies to early distributions from qualified plans (see &2157). However, the early retirement exception to the penalty does *not* apply in the case of an IRA (Code Sec. 72(t)(3)(A)).

Federal Regulation §1.408 - 1(c)(6) defines premature distributions from an individual retirement account or an individual retirement annuity as follows:

> (6) Premature Distributions. If a distribution (whether a deemed distribution or an actual distribution) is made from an individual retirement account, or individual retirement annuity to the individual for whose benefit the account was established, or who is the owner of the annuity, before the individual attains age 592 (unless the individual has become disabled within the meaning of section 72(m)(7)), a tax under chapter 1 of the code for the taxable year in which such distribution is received is increased under section 408(f)(1) or (f)(2). The increase equals ten percent of the amount of the distribution which is includable in gross income for the taxable years. . . .

DISCUSSION

Utah Code Ann. §59-10-114 provides a retirement income deduction for: "(d) amounts received by taxpayers under age 65 as retirement income which, for purposes of this section, means pensions and annuities, . . . purchased by an employee under a plan which meets the requirements of Section 408, ..." (Emphasis added).

Petitioner argues that the amounts withdrawn from his IRA account constitute retirement income from a pension or annuity purchased by him, which meets the requirements of Section 408, and those amounts are therefore appropriate retirement income deductions.

Petitioner also argues that the amounts withdrawn from his IRA account are retirement income, because the 10% additional tax on early distributions imposed by Section 72 of the Internal Revenue Code is not imposed upon these distributions. However, the reason the 10% additional tax is not imposed upon those early distributions is because of the manner in which they were distributed[1], and not based upon the age or retirement status of Petitioner.

Respondent argues that these distributions are subject to tax because they were received as an "early distribution" and are not "retirement income" under Utah Admin. Code Rule R865-9I-38. However, the only portion of Rule 38 that would apply to make these payments not "retirement income" would be either paragraph 1 which states "items are not retirement income if

1 §72(t)(2) of the Internal Revenue Code provides in relevant part, ". . . . paragraph 1 (the 10% penalty) shall not apply to . . . distributions which are . . . . (iv) part of a series of substantially equal periodic payments (not less frequently then annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary.

they are subject to the penalty or additional tax imposed by Section 72(q) or (t) of the Internal Revenue Code", and Section 3 which says the items received are not retirement income if they are "due to termination of employment before reaching a normal retirement age as established under the qualifying plan".

These items are not subject to the penalty imposed by Section 72(q) or (t) of the Internal Revenue Code, and they are not due to the termination of employment of Petitioner. Therefore, these payments are not included in the items defined by Rule 38 as being specifically not "retirement income".

The amounts in the IRA account of Petitioner were based upon a rollover from his 401(k) plan which he had with his employer when he terminated his employment. Once it was rolled into an IRA account, it was a plan governed by Section 408 of the Internal Revenue Code. Utah Code Ann. §59-10-114 specifically provides the credit for, amounts received by taxpayers under age 65 as retirement income which, for purposes of this section, means pensions and annuities, paid from an annuity contract . . . purchased by an employee under a plan which meets the requirements of section 408, Internal Revenue Code . . . ."

To attempt to determine if the payments to Petitioner from that IRA are eligible for the retirement income deduction under U.C.A. §59-10-114(2), the Commission has looked to the history of the statute and the related rule.

I. Authorities

A. Statute:

The retirement income exemption goes back at least to the recodification in 1973. Our library resources do not allow us to go back further than that.

Section 13(b) of the Utah Individual Income Tax Act of 1973 provided in part as follows:

> (b) There shall be subtracted from federal taxable income of a resident or nonresident individual:
> (3) amounts received as "retirement income" which, for purposes of this section shall mean –
> (a) pension and annuities, paid from annuity contract [sic] purchased by an employer under a plan which meets the requirements of section 404(a)(2) of the Internal Revenue Code, or the United States, a state thereof or the District of Columbia,
> (b) interest,
> (c) rent,
> (d) dividends,
> (e) subsections (b), (c), and (d) shall apply only to taxpayers who have attained the age of 65 before the close of the taxable year, and
> (f) bonds described in section 405(b)(1) [from a qualified bond purchase plan],
> (g) for purposes of this section the amount of "retirement income" subtracted shall be the lesser of the amount included in federal taxable income or $4,800 . . . .

In 1978, subsection (b)(3)(a) was amended to include pensions and annuities "purchased by an employee under . . . section 408 of the Internal Revenue Code [IRA's]."

In 1979, the income limitation for taxpayers over 65 was raised to $6,000 and the $4,800 limitation was retained for taxpayers under 65.

In 1987, the sections were rearranged. The age limitation that had been in subsection (3)(e) was moved to its own subsection, but the rearrangement does not appear to have had a material

substantive effect on the definition of "retirement income." The relevant sections, as amended, read as follows:

> (2)(a) There shall be subtracted from federal taxable income of a resident or nonresident individual:
>
> * * *
>
> (iv) amounts received as "retirement income" which, for purposes of this section, means –
>
> (A) pension and annuities, paid from an annuity contract purchased by an employer under a plan which meets the requirements of section 404(a)(2) of the Internal Revenue Code, or purchased by an employee under a plan which meets the requirements of Section 408 of the Internal Revenue Code, or paid by the United States, a state, or political subdivision thereof, or the District of Columbia, to the employee involved or the surviving spouse;
>
> (B) interest, except U.S. government bond interest deducted under Subsection (2)(a);
>
> (C) net rental income;
>
> (D) dividends; and
>
> (E) bonds described in section 405(b)(1) [from a qualified bond purchase plan].
>
> * * *
>
> (b)(ii)(A) Subsections (a)(iv)(B), (C), and (D) apply only to taxpayers who have attained the age of 65 before the close of the taxable year.

In 1988, the income limitation amounts were amended and Section 405(b)(1) bonds were removed from the definition of "retirement income."

In 1989, Second Special Session, the statute was amended to approximate its current language. Rather than receiving a reduction for specific types of income, taxpayers over 65 were given a $7,500 "personal retirement exemption." Thus, it was no longer necessary to define "retirement income" for persons over 65. Because interest, net rental income, and dividends were never considered retirement income for persons under 65, the inclusion of those items in the statute

was no longer necessary and they were all removed from the list of "retirement income." It was still necessary to define "retirement income" for persons under 65, however, so the pension and annuity provision was retained. Because the definition was only relevant for taxpayers under 65, the clause "by taxpayers under age 65" was added to the pension and annuities provision. The separate subsection that had disallowed non-pension income for taxpayers under 65 was no longer necessary and was repealed.

Immediately after the amendment, the relevant language read as follows:

> (2) There shall be subtracted from federal taxable income of a resident or nonresident individual:
>
> *** * ***
>
> (d)(i) amounts received by taxpayers under age 65 as "retirement income" which, for purposes of this section, means pension and annuities, paid from an annuity contract purchased by an employer under a plan which meets the requirements of section 404(a)(2) of the Internal Revenue Code, or purchased by an employee under a plan which meets the requirements of Section 408 of the Internal Revenue Code, or paid by the United States, a state thereof or the District of Columbia, to the employee involved or the surviving spouse.
>
> (ii) For purposes of Subsection (2)(d), the amount of "retirement income" subtracted for taxpayers under 65 shall be the lesser of the amount included in federal taxable income, or $4,800, ...
>
> *** * ***
>
> (e)(i) for each taxpayer age 65 or over before the close of the taxable year, a $7,500 personal retirement exemption; . . . .

B. Rule:

Rule R865-9-38I was originally promulgated in 1994. The Tax Commission Rule Review Checklist indicates that the rule "clarifies existing practice" and would have no fiscal impact.

The rule file indicates that Commissioner Joe Pacheco was concerned about the rule restructuring the exemption and inquired of a local CPA, as follows:

> Some practitioners have stated to me that there are some qualifying annuities that would fall under Section 59-10-114. Since I have limited research information could you please review this proposed rule and send me any information you can regarding how this language could be changed. As an example, I believe that a person under 65 could qualify some retirement income as an annuity under the Internal Revenue Code.

There was no response in the file. Nor were there any other written public comments in the file.

The rule has remained substantially unchanged since it was promulgated.

II. Analysis

A. Arguments in favor of allowing a subtraction for all distributions from qualifying pensions and annuities.

1. Statutory history.

Prior to 1989, pension and annuity income was treated as retirement income for taxpayers regardless of age. There is no statutory basis to assume "premature" or early distributions were treated differently. On the contrary, it appears that "retirement income" was specifically defined to include pension and annuity income for all taxpayers, as was bond income from qualified bond purchase plans. Other kinds of income typically reserved by retirees, such as interest income, were treated as "retirement income" only if received by taxpayers over 65.

After 1989, the definition of "retirement income" had no continuing relevance for taxpayers over 65. Items that did not constitute "retirement income" for taxpayers under 65 were

dropped from the statute. The statutory description of qualifying pensions and annuities, however, remained unchanged.

Thus, based on statutory analysis, the language of the statute argues in favor of a subtraction for all distributions from qualifying pensions and annuities.

2. Rule

The rule change was not contemporaneous with any of the material changes in the statute and was unsupported by any analysis in the rule file. The only reference that sheds any light at all is the statement in the Rule Checklist that the new rule would "clarif[y] existing practice." Even here, the use of the verb "clarify" is interesting. A clarification is necessary if there is confusion. The checklist does not say the rule would "codify" or "reflect" existing practice. Thus, there may be a question whether the pre-rule practice was clearly understood and universally applied. In short, there is nothing in the rule to overcome the statutory analysis.

3. Statutory construction.

It could be argued that the phrase in the current statute "received as retirement income" must have some meaning. Generally, each word in a statute is presumed to have some meaning and must be given some effect. If all distributions from qualifying pensions and annuities were to be subtracted from federal taxable income, the statute could just say: "There shall be deducted from federal taxable income . . . amounts received by taxpayers under age 65 from pensions and annuities, paid from [a qualified plan.]" There would be no need to mention "retirement income" at all.

This argument has some merit. The language, however, is clearly a holdover from the old statutory scheme. As originally drafted, the phrase did have independent significance. It now appears to be a derelict, rather than the result of a conscious legislative choice.

B. Arguments in favor of disallowing a subtraction for "early" distributions from qualifying pensions and annuities.

1. Statutory construction.

This is essentially the argument refuted above. The phrase "received as retirement income" must have some effect. Even if the language is a carryover, it is language that was consciously retained by the drafters and must be given some effect.

The federal provisions incorporated in the statute are designed primarily for retirees. The funds are generally designed to remain invested until later in life. There are penalties for premature distributions. The legislature, by using the phrase "retirement income" was recognizing this purpose. They also recognized, presumably, that military personnel, law enforcement personnel, firefighters, and some others typically retire before age 65. They wanted to give some recognition to that fact, but not allow full benefits. Thus, if such a pensioner had reached normal retirement age for his or her occupations, the pension or annuity would qualify as retirement income, even though the "personal retirement exemption" was not available yet. For an IRA, the normal retirement age could justifiably be set at 592--the age necessary to avoid a penalty under the Internal Revenue Code.

Section 72 of the Internal Revenue Code implies that an age of 592 is a normal retirement age for such distributions, at least for purposes of determining whether a 10% additional

tax should apply, and it refers to such tax as being imposed on "early distributions from qualified retirement plans". Distributions made on or after the date on which the employee attains the age 592 are therefore not deemed to be early distributions for Internal Revenue Code purposes. Distributions made prior to age 592 are early distributions under the Internal Revenue Code.

Federal Regulation §1.408-1(c)(6) defines a "premature distribution" as one which is made to the individual before the individual attains age 592 (unless the individual has become disabled. . . .)"

Also, instructions for coding 1099R forms requires the 1099R to be coded as an early distribution if the distribution is prior to age 592, but to be coded as a normal distribution from a plan, including a traditional IRA, if the employee/taxpayer is at least 592." Accordingly, the Internal Revenue Code and the Federal Regulations relating to individual retirement accounts have determined that IRA distributions on or after age 592 are "normal distributions", but distributions prior to age 592 are "premature distributions."

2. Longstanding administrative interpretation.

The rule is consistent with legislative intent as set out above. It gives effect to the phrase "as retirement income" in the statute.

Moreover, it has been the Commission's publicly stated position for almost 10 years. Arguably, it applies a previously existing administrative position. There was no public dissent when it was adopted. The legislature, which is presumed to be aware of our published interpretations of tax law, has not called the rule into question and has made no attempt to further clarify the statute.

Under this theory, the Tax Commission should not reverse a long-standing administrative position without legislative approval unless the position is completely unsupported by the statute itself. The rule in this case is not so egregious that it must be overturned.

III. Conclusion

After a review of the above analysis, the Commission has concluded that the arguments in favor of allowing a subtraction for all distributions from qualifying pensions and annuities are more persuasive than are the arguments in favor of disallowing a subtraction for "early" distributions from qualifying pensions and annuities. The Commission therefore determines that the statute, U.C.A. §59-10-114(2), permits a credit for "amounts received by taxpayers under age 65 as retirement income which . . . means pensions and annuities, paid from an annuity contract . . . purchased by an employee under a plan which meets the requirements of section 408, Internal Revenue Code . . . ." The statute does not contain a minimum age requirement, and it does not limit the credit to payments received after a "normal retirement age".

DECISION AND ORDER

Based upon the foregoing, it is hereby determined that the monies received by Petitioner from his individual retirement account in 1998 and 1999 qualified for the retirement income deduction provided by Utah Code Ann. §59-10-114. The audit assessment is therefore reversed, and the Petition for Redetermination is hereby granted. It is so ordered.

DATED this _____ day of _____, 2003.

_____
G. Blaine Davis
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2003.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Palmer DePaulis
Commissioner

Marc B. Johnson
Commissioner

Notice of Appeal Rights: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. ∋63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. ∋∋59-1-601 and 63-46b-13 et. seq.

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