05-1416
INCOME TAX
TAX YEAR: 2002
SIGNED: 08-07-2007
COMMISSIONERS: P. HENDRICKSON, R. JOHNSON, M. JOHNSON, D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**ORDER** Appeal No. 05-1416 Account No. ##### Tax Type: Income Tax Tax Year: 2002 Judge: Phan

Presiding:
Jane Phan, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER
For Respondent: RESPONDENT REP. 1, Assistant Attorney General
RESPONDENT REP. 2, Senior Auditor

STATEMENT OF THE CASE

This matter came before the Commission for an Initial Hearing pursuant to Utah Code Sec. 59-1-504.1, on May 21, 2007. At the hearing Petitioner contested an income tax audit deficiency for the tax year 2002. The Statutory Notice of Audit Change had been issued on August 31, 2005. The amount of additional tax at issue was $$$$$ and the interest assessed with the audit was $$$$$.

APPLICABLE LAW

Utah imposes income tax on individuals who are residents of the state, in Utah Code Sec. 59-10-104 as follows:

> ...a tax is imposed on the state taxable income, as defined in Section 59-10-112, of every resident individual...

State taxable income is defined in Utah Code Sec. 59-10-112 as follows:

> "State taxable income" in the case of a resident individual, means his federal taxable income (as defined by Section 59-10-111) with the modifications, subtractions, and adjustments provided in Section 59-10-114 . . .

Federal taxable income is defined in Utah Code Sec. 59-10-111 as follows:

> "Federal taxable income" means taxable income as currently defined in Section 63, Internal Revenue Code of 1986.

Taxable income is defined in the Internal Revenue Code at 26 U.S.C. 63 as:

> Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).

Federal Tax Credits are not allowed as a credit against Utah Individual Income Tax pursuant to Utah Code Sec. 59-10-110 as follows:

> No credit applied directly to the income tax calculated for federal income tax purposes pursuant to the Internal Revenue Code shall be applied in calculating the tax due under this chapter.

DISCUSSION

In this matter Petitioner explained that she had become disabled and had started receiving payments for disability from a disability insurance policy in 2000. She indicated this policy was to pay the insurance during the period of time it took the Social Security Administration to make a determination on her claim and if the determination was to pay her disability, her insurance policy required repayment equal to the amount that she received from Social Security for the same period. The Social Security Administration took more than two years to make a determination on her claim, but eventually in 2003 they did grant her disability payments, going back to the date of the disability. In 2003 she was then required to pay back to her insurance company the $$$$$$ that she had received in the prior years.

This caused a complicated tax situation for Petitioner and she was eventually audited by the

Internal Revenue Service. For 2002 Petitioner had originally claimed only $$$$$ in federal adjusted gross income and the IRS increased that to $$$$$. Respondent followed the IRS and increased Petitioner's state taxable income based on the increased federal, which resulted in the audit at issue in this matter.

Petitioner appealed the IRS audit and eventually the IRS determined that Petitioner qualified for Section 1341 treatment on this income. In 2006 Petitioner was issued a refund from the Internal Revenue Service related to all three-tax years that were affected, 2000-2002. However, the refund was issued as a reduction to her 2003 federal tax liability based on Section 1341.

Respondent argues that the refund was issued as a tax credit towards Petitioner's 2003 tax liability. Respondent cites to Utah Code Sec. 59-10-110, indicating that this would prohibit Respondent from allowing Petitioner the relief she requests for the 2002 tax year. Respondent indicates the IRS could have processed Petitioner's claim in different manner, or Petitioner could have filed amended federal and state returns claiming the income in the years it was received, but then claiming a deduction in 2003 when Petitioner was required to repay the tax.

Upon review of the information presented and the applicable law, the Commission concludes that the IRS did make an adjustment to Petitioner's federal tax under Internal Revenue Code Sec. 1341. However, this resolution in Petitioner's favor was in a manner that Respondent indicates it is unable to apply to the 2002 tax year. Petitioner provided the schedules from the IRS Appeals Officer who decided her case. The Commission notes that the IRS work papers in which the amount was calculated refer to the amount as a "Section 1341 reduction." Sec. 1341 provides that the tax imposed be the lesser of the tax calculated in two separate methods. The first method, after having correctly claimed the income as taxable in the prior years, was that the taxpayer deduct the repayment in the year that is was repaid. The second method is to determine the amount by the decrease in tax for the prior year or years, which would result solely from the exclusion of such item from gross income for the prior years.

Based on the IRS work papers that Petitioner presented it appears the IRS calculated the adjustment using the second method. The IRS looked at Petitioner's federal taxable income for 2000, 2001 and 2002 and made a Section 1341 reduction to that taxable income to determine a new tax liability for each of the years. It appears from the IRS worksheets that the difference between the tax calculated with this reduction and the tax that Petitioner had paid with her returns for these years was added and refunded to Petitioner as an overpayment of tax relating to her 2003 federal income tax filing. In 2006 Petitioner received a refund from the IRS for the 2003 tax year in the amount of $$$$$.

Respondent acknowledged that Petitioner is likely barred by the Utah statute of limitations for obtaining a Utah refund for 2003. If she is required to pay the audit for 2002, and not allowed a refund for 2003, she will end up essentially paying tax on these funds both in 2002 and 2003. She will pay tax for 2002 on the insurance proceeds that she later had to repay and for 2003 on the Social Security payments she received as a replacement for the insurance proceeds.

The Tax Commission has applied in very limited circumstances the doctrine of equitable recoupment to those situations where there is an audit assessment for one year and arising from the same transaction or taxable event an overpayment in another year, but where the taxpayer is barred from claiming a refund of the overpayment by the statute of limitations.[1] The Commission has found this doctrine to apply in limited circumstances but concludes that based on the information before it in this matter, it is appropriate to make this adjustment so Petitioner is not paying tax in 2002 and 2003 on what is essentially the same income.

When the IRS calculated the amount of the tax reduction for 2003 it determined that Petitioner's 2002 federal taxable income after subtracting the Section 1341 reduction to be $$$$$. This is very

1 In Tax Commission Appeal No. 01-0670, pg 3, the Commission concluded that the doctrine of equitable recoupment could be applied to offset an audit deficiency if the following criteria have been met: 1) a payment of tax was made in a year that is now barred by the statute of limitations; 2) an assessment of tax has now been made arising out of the same transaction, item or taxable event as the one that gave rise to the overpayment; and 3) the transaction, item or taxable event is now being subject to double taxation.

similar to the amount of federal adjusted gross income that Petitioner had indicated on her Utah individual income tax return for 2002 and supports abatement of the audit.

DECISION AND ORDER

Based upon the foregoing, the Commission abates the audit as indicated in the Statutory Notice of Audit dated August 31, 2005, pertaining to tax year 2002. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2007.

_____
Jane Phan, 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 _____, 2007.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

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