

09-1025  
TAX TYPE: INCOME TAX  
TAX YEAR: 2006 & 2006  
DATE SIGNED: NOT AVAILABLE  
COMMISSIONERS: M. JOHNSON, D. DIXON, M. CRAGUN  
EXCUSED: B. JOHNSON  
GUIDING DECISION

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BEFORE THE UTAH STATE TAX COMMISSION

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TAXPAYER-1 & TAXPAYER-2,

Petitioners,

v.

AUDITING DIVISION OF THE UTAH STATE  
TAX COMMISSION,

Respondent.

**FINDINGS OF FACT, CONCLUSIONS OF  
LAW AND FINAL DECISION**

Appeal No. 09-1025

Account No. #####

Tax Type: Income Tax

Tax Year: 2005 & 2006

Judge: Phan

**Presiding:**

Michael Cragun, Commissioner

Jane Phan, Administrative Law Judge

**Appearances:**

For Petitioner: TAXPAYER-1

TAXPAYER-2

For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General

RESPONDENT-1, Manager, Income Tax Auditing

RESPONDENT-2, Auditor

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on September 6, 2011, pursuant to the provisions of Utah Code §§59-1-501 and 63G-4-204 et al. The matter is before the Commission on Petitioners' ("Taxpayers") appeal of audit deficiencies for the tax years 2005 and 2006. Based upon the evidence and testimony presented at the hearing the Tax Commission hereby makes its:

FINDINGS OF FACT

1. Respondent ("Division") audited the Taxpayers' Utah Individual Income Tax Returns for tax years 2005 and 2006. The Taxpayers timely appealed the income tax and interest deficiencies and the matter proceeded to this Formal Hearing before the State Tax Commission. The Statutory Notices of Deficiency and Audit Change had been issued on January 28, 2009. No penalties were assessed with the audit.

2. The amount of the deficiency indicated in the Statutory Notices is as follows:

Year	Tax	Interest	Total <sup>1</sup>
2005	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
2006	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$

3. The Taxpayers had filed Utah Resident Individual Income Tax Returns as well as Federal Income Tax returns for each of the years at issue. In the audit, the Division disallowed a portion of the amount the Taxpayers had claimed on their Utah returns for deduction for interest from U.S. Government obligations.

4. For some period of time TAXPAYER-1 had been self employed and had established a profit sharing defined contribution plan or Keogh in 1990. The Taxpayers described this as a tax-deferred savings plan that allows self-employed persons and employees to save money for retirement. He provided a copy of a letter from the Internal Revenue Service dated March 1, 1990, which stated that the plan was acceptable under Section 401 of the Internal Revenue Code. The plan was then amended and restated in 1996.

5. TAXPAYER-1 was the only trustee of the Keogh plan, the only participant and contributor to the plan and the only person entitled to distributions from the plan. The plan amount was invested entirely in U.S. Treasury Obligations.

6. The Keogh plan was a separate legal entity for tax purposes from TAXPAYER-1. It has its own tax identification that is separate from TAXPAYER-1'S social security number and when the plan issues distributions to TAXPAYER-1, it issues a 1099-R to TAXPAYER-1 showing the distribution or transfer.

7. The Taxpayers explained that after TAXPAYER-1 reached ##### years of age, Internal Revenue Service rules provide that the plan issue to TAXPAYER-1 a required minim distribution (RMD) each year. The RMD amount is determined by dividing the account balance by TAXPAYER-1'S life expectancy. The Taxpayers point out that the RMD is dependent on the amount of interest received from the government obligations in which the plan is invested. The first year that a distribution was required to be made to TAXPAYER-1 was 2005. He also received a distribution in 2006.

8. For the 2005 tax year, the Taxpayers had claimed \$\$\$\$\$ as a deduction on their Utah Individual Income Tax Return for interest from U.S. Government Obligations. The Division disallowed \$\$\$\$\$ of this amount, allowing only \$\$\$\$\$ as the deduction. It was the Taxpayers' position that the \$\$\$\$\$ was the \$\$\$\$\$ in deferred interest and \$\$\$\$\$ in current year's interest from the government obligations received by the Keogh plan. That TAXPAYER-1'S KEOGH plan had received current year's interest of \$\$\$\$\$ from U.S. Treasury Obligations, was supported by a 1099-INT, issued for the 2005 year from the Treasury Department to

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<sup>1</sup> Interest as calculated to the date of the Statutory Notices. Interest continues to accrue on any unpaid balance.

TAXPAYER-1, Trustee of the TAXPAYER-1 Self Employed Retirement Plan. They represent that the \$\$\$\$ was for interest that had been received in prior years. A 1099-R indicated that the Keogh plan had paid to TAXPAYER-1 the amount of \$\$\$\$ in 2005.

9. On their 2005 Federal Individual Income Tax Return, the Taxpayers had claimed on Line 15a IRA distributions, the amount of \$\$\$\$. They explained at the hearing that the \$\$\$\$ consisted of the \$\$\$\$ from the distribution from the Keogh plan that they attributed to U.S. Government interest and an additional IRA distribution not related to the Keogh plan in the amount of \$\$\$\$.

10. On their Utah Individual Income Tax return for 2005 the Taxpayers claimed \$\$\$\$ on Line 13- Other Deductions. On the Supplemental Schedule attached to the form they indicate of this amount \$\$\$\$ is for interest from U.S. Government Obligations and \$\$\$\$ is for Gains on capital transactions. At the hearing, they explained that of the \$\$\$\$ interest amount, the \$\$\$\$ is for the government interest received in the Keogh plan and the remaining \$\$\$\$ is from an unrelated joint account from which they received interest on U.S. Government obligations. This \$\$\$\$ had been included as interest income on the Taxpayers' federal return.

11. In the audit, the Division disallowed the interest from U.S. Government obligations deduction for the \$\$\$\$\$, but allowed the deduction for the remaining \$\$\$\$.

12. For the 2006 year, there were some differences on their tax filings. In 2006 the Taxpayers had claimed \$\$\$\$ as a deduction on their Utah Individual Income Tax Return for interest from U.S. Government Obligations. The Division disallowed \$\$\$\$ of this amount, reducing the deduction to \$\$\$\$\$. It was the Taxpayers' position that the disallowed portion of \$\$\$\$ was from what they attributed to be \$\$\$\$ in deferred government obligation interest and \$\$\$\$ in current year's interest paid to TAXPAYER-1'S Keogh plan.

13. A 1099-INT for 2006 provided from the Treasury indicated \$\$\$\$ in government obligation interest had been paid to "TAXPAYER-1, Trustee of the TAXPAYER-1 Self Employed Retirement Plan." Unlike for the 2005 tax year it does not appear that a distribution was made from the plan to TAXPAYER-1 for all of the \$\$\$\$ claimed as government interest obligation deduction. The only 1099-R provided indicated that the plan had paid to TAXPAYER-1 the amount of \$\$\$\$ in 2006.

14. On their 2006 Federal Individual Income Tax Return, the Taxpayers had claimed on Line 15a- IRA Distributions, the amount of \$\$\$\$. They explain at the hearing that the \$\$\$\$ consisted of the \$\$\$\$ which was the amount distributed to TAXPAYER-1 from his retirement plan and an IRA distribution unrelated to the plan in the amount of \$\$\$\$.

15. On their Utah Individual Income Tax return for 2006 the Taxpayers claimed \$\$\$\$ on Line

13- Other Deductions. On the Supplemental Schedule attached to the form they indicate this entire amount is for interest from U.S. Government Obligations. At the hearing, they explained that of the \$\$\$\$ interest amount, \$\$\$\$ is from the Keogh plan and the remaining \$\$\$\$ is from a joint account that was not related to the Keogh plan, from which they received interest on U.S. Government obligations. The \$\$\$\$ had been claimed as interest income on their federal return.

16. In the audit, the Division disallowed the interest from U.S. Government obligations deduction for the \$\$\$\$ , but allowed the deduction for the remaining \$\$\$\$ that had been interest income from the joint account.

17. The Taxpayers testified that as 2005 approached and they knew they would be receiving RMD distributions from the Keogh plan, they sought advice from Utah Tax Commission employees on how they should file returns to recapture previously deferred treasury interest. They testified that when they originally approached the Tax Commission staff over 20 years ago, they were told by the staff at that time that they did not know how the Taxpayers should file their returns.

APPLICABLE LAW

Utah imposes income tax on individuals who are residents of the state, in Utah Code §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 §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 . . .

Utah Code §59-10-114(2)(2006)<sup>2</sup> provides a deduction for interest or dividends on obligations or securities of the United States as follows:

There shall be subtracted from federal taxable income of a resident or nonresident individual: (a) the interest or a dividend on obligations or securities of the United States and its possessions or of any authority, commission or instrumentality of the United States, to the extent that interest or divided is included in gross income for federal income tax purposes for the taxable year but exempt from state income taxes under the laws of the United States, but the amount subtracted under this Subsection (2)(a) shall be reduced by any interest on indebtedness incurred or continued to

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2 Section 59-10-114(2)(a) has been amended since the tax years at issue in this appeal.

purchase or carry the obligations or securities described in this Subjection (2)(a), and by any expenses incurred in the production of interest or dividend income described in this Subsection (2)(a) to the extent that such expenses, including amortizable bond premiums, are deductible in determining federal taxable income;

. . . .

31 USC §3124(a) states:

Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax . . .

IRC §401(a) (2006) states in part, “A trust created or organized in the United States and forming part of a . . . profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section . . .”

IRC §402(a) (2006) states in part, “Except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72(relating to annuities).”

IRC §4974(c) states in part:

For purposes of this section, the term “qualified retirement plan” means--

- (1) a plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

. . . .

Utah Code §59-1-401(13) (2010) provides that “[u]pon making a record of its actions, and upon reasonable cause shown, the commission may waive, reduce, or compromise any of the penalties or interest imposed under this part.”

Utah Admin. Rule R865-1A-42(2) (“Rule 42”) (2010) provides guidance concerning the waiver of interest, as follows:

- (2) Reasonable Cause for Waiver of Interest. Grounds for waiving interest are more stringent than for penalty. To be granted a waiver of interest, the taxpayer must prove that the commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error.

Utah Code §59-1-1417 provides that the burden of proof is upon the petitioner in proceedings before the Commission:

In a proceeding before the commission, the burden of proof is on the petitioner . . . .

DISCUSSION

The Taxpayers in this matter request that they be allowed deductions on their Utah returns for amounts they attributed to treasury interest received by TAXPAYER-1'S qualified profit sharing plan or KEOGH. There was some difference between the Taxpayer's filings for the two tax years at issue in this appeal. For the 2005 tax year it appears that the amount of the deduction that the Division had disallowed, \$\$\$\$\$, was claimed by the Taxpayers as federal taxable income on their federal return on Line 15a, because they had requested a deduction that was the same amount as their distribution from the KEOGH plan.

Under Utah Code §59-10-114(2), to qualify for the deduction for government obligation interest, among other requirements, the amount must be claimed as gross income on the federal return. For 2006, however, most of the \$\$\$\$\$ amount for which the Taxpayers request the deduction on their Utah return, was not included in their gross income on their federal return. TAXPAYER-1'S plan had received \$\$\$\$\$ in interest during 2006 and the plan likely had accumulated interest from prior years, but the plan had only paid out to TAXPAYER-1 \$\$\$\$\$ as a distribution. The \$\$\$\$\$ distribution was claimed by the Taxpayers as income on their 2006 federal tax return, while the Taxpayers claimed \$\$\$\$\$ in deductions on their Utah return. The Taxpayers made the distinction at the hearing that they were not asking for exemption of the distribution, but instead for the deduction of treasury interest that the plan received and deferred or accumulated.

However, under the statutory provisions, there is no basis for the Taxpayers to claim a deduction for treasury interest on amounts they are not claiming in their federal adjusted gross income. Under Utah Code §59-10-114(2), even if other requirements were met, most of the \$\$\$\$\$ would not qualify for the deduction because it was not claimed as income on their federal return. The Taxpayers' argument that requiring they claim the interest income on the federal return in order to qualify for a deduction on the state return is double taxation or a violation of 31 USC §3124 is not persuasive because if the interest income is not claimed as income on the federal return, it would not be included in the Utah taxable income and, therefore, would not be subject to tax. The federal law at 31 USC §3124(a) provides only that, "obligations of the United States Government are exempt from taxation by a State or political subdivision." As Utah taxable income is based on federal taxable income, if the interest income is not included in the federal taxable income, it is not subject to Utah tax in the first place, so there is nothing to exempt. Utah Code §59-10-114(2) is consistent with federal 31 USC §3124(a) and appropriately tailors the provision based on the Utah law by indicating that there is no Utah deduction for the interest unless the interest is claimed in the federal taxable income. Therefore, there is no basis for the Taxpayers' claim that they be allowed a deduction for treasury interest received by the plan

when it was not included in their taxable income.

Regarding the 2005 deduction and the portion of the 2006 deduction that equated to TAXPAYER-1'S distribution, this could arguably be considered to have been included in the Taxpayers federal taxable income. However, as argued by the Division, the U.S. obligation interest was not paid directly to TAXPAYER-1. It was paid to his Keogh plan. Even though TAXPAYER-1 is the trustee, distributee and sole participant, the Keogh plan is a separate legal entity from TAXPAYER-1. What TAXPAYER-1 receives is a distribution from the Keogh plan. Although the required minimum distribution amount would be affected by the amount of U.S. obligation interest the Keogh received, it does not change the fact that the interest is paid to the Keogh plan and not TAXPAYER-1.

Neither side was able to find and present case law in Utah on this issue, but as the Division noted it is something that has been considered in other jurisdictions. The State Board of Equalization of California considered facts very similar to those in this matter in *Amir H. Shahandeh*, 2000 WL 1872954 (Ca. St. Bd.Eq.). In that case Mr. Shahandeh had established a qualified pension plan and was the trustee and sole participant in the plan. The plan was invested solely in United States Treasury Bills. The pension plan had received and accumulated interest from these obligations and made a distribution to Mr. Shahandeh. Mr. Shahandeh argued the distribution was exempt from taxation because it consisted entirely of interest from federal obligations. After reviewing decisions in other jurisdictions the California State Board of Equalization upheld the California state tax on the distribution.

The Division also points to a Minnesota Tax Court decision based on facts that are very similar to the Taxpayers in this matter. In *Cherne v Commissioner of Revenue*, 1996 WL 337043 (Minn. Tax) the court also found taxable to the distributee a distribution from an IRS 401 qualified profit sharing plan. In that case there were two participants in the plan and the plan was invested solely in U.S. government obligations. In that matter, Mr. Cherne claimed that the portion of the distribution that could be attributed to Treasury bill interest should be exempt as government interest. The court in *Cherne* concluded that 31 USC 3124(a) did not require Minnesota to exempt the distribution, noting the following IRS Revenue Ruling:

Although a distribution from an employees' trust meeting the requirements of section 401 of the Internal Revenue Code of 1954 is made in whole or in part from funds received by the trust as interest on tax-free securities, such distribution, when received or made available, is taxable income to the distributee in the manner and to the extent provided by section 402(a) of the Code.

Rev. Rul. 55-61, 1955-1 CB 40.

The Division also cited to *Meunier v Minnesota Department of Revenue*, 503 N.W.2d 125 (1993), in

which the Supreme Court of Minnesota had previously concluded that annuity payments from a federal employees qualified pension plan, which the employees argued were derived from U.S. Government interest, were not exempt from tax.

As noted by the Taxpayers in this case, the matter before this Commission does not involve annuity payments. However, the subsequent Minnesota decision in *Cherne*, which did not involve annuities, was consistent in result to the *Meunier* findings.

In this matter, the Taxpayers' qualified retirement plan is a profit-sharing plan under IRC §401 and not an annuity plan described in IRC §403. Plans or trusts that qualify under IRC §401 may be exempt from taxation under IRC §501 at the trust or plan level. The income is instead taxed to the distributee when distributions are made from the trust or plan as dictated by IRC §402. IRC §402 provides "any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee." Although §402 addresses directly trust or plans that are exempt under IRC §501, and not the government interest obligations that are the subject of this appeal, the case law and revenue ruling discussed above support the Division's position that the distribution made by the Keogh plan to TAXPAYER-1 does not qualify for exemption as government obligation interest and the Division's position regarding the tax deficiency for each year should be upheld.

A second issue presented in this matter was whether a basis for waiver of interest has been supported by the Taxpayers. The Taxpayers testified that as the time approached that TAXPAYER-1 would have a required minimum distribution from his Keogh plan, they asked Tax Commission employees how to file for the plan's treasury interest income, including recapturing previously deferred treasury interest. They indicated that none of the people with whom they had spoken could give them an answer and they were still waiting. From the amount of documentation that they have presented at this hearing and the thoroughness of the briefing and other preparation, the Taxpayers demonstrated a very significant effort toward compliance of the tax issues and there was no information refuting that the Taxpayers had sought advice on this issue. Upon review of their request it is clear they should have been told there is no exemption for government interest amounts not claimed in federal adjusted gross income, nor for distributions from their Keogh plan. After consideration, basis for waiver of interest has been shown.

#### CONCLUSION OF LAW

1. Under Utah Code §59-10-114(2) and 31 USC §3124(a), the Taxpayers are not entitled to an exemption for government obligation interest on amounts that they are not including in their federal taxable income.



2. Further, these same statutory provisions do not extend to exempt government obligation interest on the Taxpayers' individual income tax return, for interest that is paid to TAXPAYER-1'S Keogh plan, even when the plan distributes an equivalent amount to TAXPAYER-1. The Keogh plan is a separate entity from TAXPAYER-1 for tax purposes. It is that entity that is being paid the government obligation interest, which payment is reported under the plan's taxpayer identification number. Distributions from the plan are taxable to TAXPAYER-1.

2. Sufficient cause has been shown under Utah Code §59-1-401(13) and Utah Admin. Rule R865-1A-42(2) for waiver of the interest.

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Jane Phan  
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Tax Commission sustains the audit deficiency assessed against the Taxpayers of individual income tax for years 2005 and 2006. The Commission waives the interest for both years that was assessed with the audits. It is so ordered.

R. Bruce Johnson  
Commission Chair

Marc B. Johnson  
Commissioner

D'Arcy Dixon Pignanelli  
Commissioner

Michael J. Cragun  
Commissioner

**Notice: Failure to pay within thirty days the balance that results from this order may result in additional penalties and interest. 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. Sec. 63G-4-302. 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 Sec. 59-1-601 et seq. and 63G-4-401 et seq.

Appeal No. 07-0563