

09-2819
INCOME
TAX YEAR: 2006
SIGNED: 09-27-2010

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2,

Petitioners,

v.

AUDITING DIVISION OF THE UTAH STATE
TAX COMMISSION,

Respondent.

INITIAL HEARING ORDER

Appeal No. 09-2819

Account No. #####

Tax Type: Income Tax

Tax Year: 2006

Judge: Phan

Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER 2

For Respondent: RESPONDENT REP., Manager, Income Tax Auditing

STATEMENT OF THE CASE

This matter came before the Commission for an Initial Hearing pursuant to Utah Code Sec. 59-1-502.5, on June 15, 2010. The matter was before the Commission on Petitioners' appeal of a Utah individual income tax audit deficiency for tax year 2006. The Statutory Notice of Audit Change had been issued on August 6, 2009. The amount of the deficiency was \$\$\$\$ in tax and \$\$\$\$ in interest as of the date of the notice. Interest continues to accrue on the unpaid balance. No penalties were assessed with the audit.

APPLICABLE LAW

During the tax year at issue, Utah imposed income tax on individuals who are residents of the state, in Utah Code Sec. 59-10-104 (2006)¹ as follows:

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

¹ There have been subsequent revisions and renumberings of provisions to the Utah Individual Income Tax Act. The Commission applies the act as it was in effect for the tax year at issue and cites to the provisions as they were numbered during that period.

State taxable income is defined in Utah Code Sec. 59-10-112 (2006) 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 (2006) as follows:

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

Interest is assessed pursuant to Utah Code Sec. 59-1-402(5) as follows:

Interest on any underpayment, deficiency or delinquency of any tax or fee administered by the tax commission shall be computed from the time the original return is due excluding any filing or payment extensions, to the date the payment is received.

DISCUSSION

The Division did not provide information to refute any of the factual representations made by the Taxpayers. The Taxpayers explained that they had purchased a life insurance policy from INSURANCE COMPANY sometime prior to 1980. In 1980 they had moved to Utah from STATE 1. The Taxpayers stated that they had called and written to INSURANCE COMPANY in 1980, canceling the policy. They obtained a new policy in Utah from a different company. It was their understanding that by canceling the policy they would receive no money back and would have no insurance coverage.

They then had started receiving notices saying that the policy had lapsed, which was what they wanted so they kept throwing away the notices or requests to reinstate the policy after they had written to INSURANCE COMPANY and called the agent to stop the policy. They thought the policy was closed by that point and did not pay much attention to letters sent from the company. They stated that they never paid a premium or asked that an amount be paid for them after canceling the policy. They submitted a letter from INSURANCE COMPANY dated October 31, 1995 that stated the policy had lapsed. It went on to explain that they could reinstate the coverage if the Taxpayers paid the premium with a "DPPO" election form that was enclosed. They said they never sent in either the premium or the form. Then in 2006 INSURANCE COMPANY Company Issued a 1099-R to them in the amount of \$\$\$\$\$. The Taxpayers state that they never

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received a payment of money from the company in 2006 and did not understand why they had been issued the 1099-R.

After the Internal Revenue Services had audited their return they did contact INSURANCE COMPANY to find out why they had issued the 1099-R and were told that the company had automatically been paying the premiums all those years for them and the policy remained active until 2006. INSURANCE COMPANY had been sending the Taxpayers' notices to that affect and the Taxpayers had obtained some of these letters and submitted them to the Division. There were letters sent by INSURANCE COMPANY to the Taxpayers on December 6, 2000, December 8, 2003 and December 6, 2004. These letters all said nearly the same thing. The December 2000 letter stated the following:

I am writing to inform you that because we did not receive your premium payment of \$\$\$\$\$, which was due October 1, 2000, your policy has been kept in force through the Default Premium Payment Option (DPPO) you elected. Under this option, dividend credits were used to pay your overdue premium.

Although you also have the Automatic Premium Loan (APL) provision, the DPPO arrangement takes effect before an APL. By using dividends, it is not necessary to create a new policy loan with associated policy loan interest.

Then a letter was issued to the Taxpayers on December 1, 2005, telling them their policy had lapsed for failure to make a payment. This letter also told them to reinstate the policy they would have to pay in addition to the premium of \$\$\$\$\$ loan interest of \$\$\$\$\$. Then on January 5, 2006 another letter was generated by INSURANCE COMPANY telling the Taxpayers that the policy had lapsed and any insurance benefits had ended but because the policy had accrued cash value they still had benefits on the Options Upon Lapse terms of their contract. The letter goes on to state:

Under that provision we applied your policy's net cash value of \$\$\$\$\$ to purchase \$\$\$\$\$ of extended term insurance. The expiration date of this insurance is September 24, 2008. In computing your policy's net cash value, we deducted the amount of your outstanding loan plus loan interest for the policy's gross cash value and cancelled the loan. (The lapse of your policy resulted in a taxable gain of \$\$\$\$\$, which we are required to report to the Internal Revenue Service and any applicable state authorities.)

The Taxpayer explained that they did attempt to contest the audit with the IRS as they thought it was very unfair that they had to pay tax on a 1099-R when they had not received the income reported. They also stated they did not understand how the Insurance Company could keep continuing the policy for so many years after they thought it was canceled. However, they were unable to get the IRS to change its audit. The Taxpayers also asked that penalties and interest be waived due to their current financial hardship situation.

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There had been one additional change in the audit regarding some unreported social security income which the Taxpayers did not contest. They explained that they just had not been aware that they needed to claim this.

The Division argued in this matter that because the income listed in the 1099-R form INSURANCE COMPANY had been included by the IRS in the Taxpayers' federal taxable income, the Division was required to make the same change to its state taxable income based on the Utah Code.

Upon review of the information presented by the parties in this matter and the applicable law, because Utah Code Sec. 59-10-112 provides that Utah taxable income is based on federal taxable income the Commission must include the amount from the 1099-R if it would be federal taxable income. Further, the Commission does give the IRS deference on its determinations of what should be included in federal taxable income. The Taxpayer would have to demonstrate that the income in question was clearly something that should not have been included. In this case the Taxpayer has failed to do so. INSURANCE COMPANY did issue a 1099-R to the Taxpayers in the amount of \$\$\$\$\$. The Taxpayers argue they never received money from INSURANCE COMPANY, but there are other types of distributions that are included in federal taxable income. It appears that this may have been considered a distribution based on the cancellation of a loan taken out automatically to keep renewing the insurance, or in part to purchase term insurance. If so it is possible it was a taxable distribution regardless of there not being a cash payout. Although the Taxpayers question the actions of the life insurance company, the Tax Commission is not the government agency with jurisdiction to review or make findings as to whether the actions of the company were unlawful.

No penalties were assessed with the audit. Interest was assessed with the audit as is provided by law. Interest may be waived pursuant to Utah Code Sec. 59-10-401 upon a showing of reasonable cause and is generally waived only in the event a Tax Commission employee error causes the underpayment. There is no showing of error on the part of the Tax Commission and, therefore, no basis to waive the interest. After this appeal is closed the Taxpayers may contact the Taxpayer Services Division at 801-297-7703 to discuss options based on financial hardship including setting up an installment plan.

The audit should be sustained in this matter.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

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Based upon the foregoing, the Commission sustains the audit deficiency of tax and interest for the Taxpayers' 2006 Utah individual income tax. 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 _____, 2010.

R. Bruce Johnson
Commission Chair

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Notice: Unless a party requests a Formal Hearing, the balance of tax and interest resulting from this decision must be paid within thirty days from the date this decision is issued or an additional late payment penalty may be assessed.

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