

11-1185
TAX TYPE: INCOME TAX
TAX YEAR: 2005
DATE SIGNED: 8-4-2014
COMMISSIONERS: B. JOHNSON, M. CRAGUN, R. PERO
EXCUSED: D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER-1 & PETITIONER-2, Petitioners, vs. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION Appeal No. 11-1185 Account No. ##### Tax Type: Income Tax Tax Years: 2005 Judge: Phan
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Presiding:

R. Bruce Johnson, Commission Chair
Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER-1, By Telephone
For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney
General
RESPONDENT, Manager, Income Tax Auditing

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on April 17, 2014, in accordance with Utah Code §59-1-501 and §63G-4-201 et seq. Based upon the evidence and testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. Petitioners are appealing an individual income tax audit deficiency issued against them for tax year 2005.¹ The original Notice of Deficiency and Estimated

¹ Audits had been issued for tax years 2005, 2006 & 2007. Appeals for tax years 2006 and 2007 were dismissed by Order on Respondent's Motion to Dismiss, issued by the Commission on November 6, 2012.

Income Tax had been issued on February 14, 2011. An amended Notice of Deficiency and Estimated Income Tax was issued on January 20, 2012.²

2. The amount of the deficiency for the 2005 tax year in the original notice and then the amended notice is as follows:

Year	Tax	Interest	Penalty	Total as of Notice Date ³
Original Notice				
2005	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
Amended Notice				
2005	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$

3. The penalties assessed were 10% late filing and 10% late payment penalties under Utah Code Sec. 59-1-401.

4. Petitioners timely appealed the 2005 Notice of Deficiency and the matter proceeded to the Formal Hearing.

5. Petitioners did not refute that they were part year residents of Utah during 2005.

6. Petitioners did not file a Utah Part-Year Resident Individual Income Tax Return for the 2005 tax year when it was due in April of 2006. The audit deficiency is a non-filing estimate.

7. Petitioners did not refute that they had received income in the form of wages or compensation for their services, while working in Utah during 2005. BUSINESS-1 had issued a W-2 for PETITIONER-1, which reported Utah wage income in the amount of \$\$\$\$\$. BUSINESS-2 had issued a W-2 for PETITIONER-2 that indicated \$\$\$\$\$ in Utah wages. This was a total of \$\$\$\$\$ in Utah adjusted gross income. Both Petitioners had worked some outside of Utah before moving into Utah during 2005. The Audit shows in \$\$\$\$\$ in total adjusted gross income and the \$\$\$\$\$ in Utah adjusted gross income.

8. Petitioners argued that they were not required to file individual income tax returns and were not subject to Utah income tax on their income. In making their argument they state that they relied on the advice of an attorney in Utah. As basis for their argument, the Petitioner offered as Exhibit B a letter that they had received from the Internal Revenue Service. This letter was issued on May 9, 2003 and was regarding a "Form W-4 Dated January 14, 2003," which was "Claimed: Exempt." The letter was from NAME-1, Tax Examiner, addressed to PETITIONER-1 and states:

² Respondent's Exhibits 1.

³ Interest continues to accrue on the unpaid balance.

We reviewed your additional information supporting your Form W-4, Employee's Withholding Allowance Certificate, described above and decided that your Form W-4 is acceptable. We have instructed your employer to honor it. However, if you should claim exemption from withholding or claim 11 or more withholding allowances on any future Form W-4, your employer is required by law to send us a copy.

We apologize for any inconveniences we may have caused you. If you have questions, please write to us at the address shown on this letter, or call us weekdays between 7:00 am and 4:30 pm Pacific time at PHONE NUMBER (toll call).

9. Petitioner refers to the IRS's 2003 letter as a "lock in letter" or an exemption certificate. Petitioner also alleges that the reason the IRS had granted the exemption from withholding was due to the argument and information he had presented to the IRS that his wage income was not subject to income tax. He testifies that the argument and information he had presented to the IRS was the same as his Exhibit A submitted at this hearing and provided a copy of an Affidavit, dated June 30, 2003,⁴ listing information he had provided to the IRS in support of his W-4 request.

10. Petitioner had filed the same type of request for exemption from withholding with the IRS for years after 2003 and states that he had never received an exemption letter back from the IRS for these other years.

11. In fact, this letter from the IRS indicates only that Petitioners are exempt from withholding requirements for that year, it does not indicate he is exempt from tax for that year. It also provides no indication why the exemption from withholding had been granted.

12. In Petitioner's Exhibit D, the Petitioner provided information published on the State Tax Commission's website at tax.utah.gov for employers regarding withholding. Under the heading "Who Must Withhold Taxes" it states, "You must withhold Utah income tax (unless the employee has filed a federal withholding exemption certificate) if you . . ."

13. Petitioner testified at the hearing that the IRS never challenged or revised the "lock in letter." However, he states the IRS had "completely ignored" this letter in assessing taxes with liens, levies and judgments against the Petitioners for numerous tax years. Petitioners are now trying to work out an Offer in Compromise with the IRS and are looking for a restart or redo. Petitioner argues that he had spent \$\$\$\$ on getting attorneys to get this done and noted the stress that it had caused. He stated that he was following the advice of a Utah Attorney, NAME-2⁵ and

⁴ Petitioner's Exhibit C.

⁵ Petitioner represented that NAME-2 is an attorney. The Tax Commission makes no such representation.

it was still his contention that he was following the law and he and his wife were exempt from tax on their wage income.

14. The Division's audit amounts were based on information the Division had received from the Internal Revenue Service. The Division provided a copy of the Account Transcript from the IRS on the Petitioners, which indicated in \$\$\$\$ federal adjusted gross income⁶ as well as W-2 information that had been reported to the IRS by Petitioners' employers for the 2005 tax year.⁷

APPLICABLE LAW

Under Utah Code §59-10-104 (2005),⁸ a tax is imposed on the "state taxable income" of every "resident individual."

In this matter the Taxpayers changed status from nonresident to residents of Utah. Utah Code Sec. 59-10-120 (2005) provides:

- (1) If an individual changes his status during his taxable year from resident to nonresident or from nonresident to resident, the commission may be rule require him to file one return for the portion of the year during which he is a resident and another return for the portion of the year during which he is a nonresident.
- (2) Except as provided in Subsection (3) the taxable income of the individual described in Subsection (1) shall be determined as provided in this chapter for residents and for nonresidents as if the individual's taxable year for federal income tax purposes were limited to the period of his resident and nonresident status respectively.

"State taxable income" is defined in Utah Code §59-10-112 (2005) 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 59-10-209.

"Federal taxable income" is defined in Utah Code §59-10-111 (2005) to mean:

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

Taxable income is defined in §63 of the Internal Revenue Code, set forth below:

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).

⁶ Respondent's Exhibit 3.

⁷ Respondent's Exhibit 4.

⁸ The Code has been revised and renumber since the tax years at issue. The Commission applies the substantive provisions that were in effect during the audit years.

For purposes of determining “taxable income” Section 61 of the Internal Revenue Code defines “gross income” as follows:

- (a) Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
 - (2) Gross income derived from business;
 - (3) Gains derived from dealings in property;
 - (4) Interest;
 - (5) Rents;
 - (6) Royalties;
 - (7) Dividends;
 - (8) Alimony and separate maintenance payments;
 - (9) Annuities;
 - (10) Income from life insurance and endowment contracts;
 - (11) Pensions;
 - (12) Income from discharge of indebtedness;
 - (13) Distributive share of partnership gross income;
 - (14) Income in respect of a decedent; and
 - (15) Income from an interest in an estate or trust.

Utah law provides for penalties where returns are filed late or payment has been made late at Utah Code §59-1-401 which provides in pertinent part:

(I) person that files a return after the due date as described in Subsection (2)(a) is subject to the penalty described Subsection 2(c)(ii); and (II) a person that fails to pay the tax, fee, or charge as described in Subsection (3)(a) is subject to the penalty described in Subsection (3)(b)(ii). Utah Code Sec. 59-1-401(1)(a)(ii)(B).

Interest on any underpayment or deficiency of any tax or fee administered by the Commission is provided at Utah Code §59-1-402(6) as follows:

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

Utah Code §59-1-1417 provides, “[i]n a proceeding before the commission, the burden of proof is on the petitioner...”

Upon 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 Code Sec. 59-1-401(13).

The Commission has promulgated Administrative Rule R861-1A-42 to provide additional guidance on the waiver of penalties and interest, as follows in pertinent part:

- (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.
- (3) Reasonable Cause for Waiver of Penalty. The following clearly documented circumstances may constitute reasonable cause for a waiver of penalty:
 - (a) Timely Mailing...
 - (b) Wrong Filing Place...
 - (c) Death or Serious Illness...
 - (d) Unavoidable Absence...
 - (e) Disaster Relief...
 - (f) Reliance on Erroneous Tax Commission Information...
 - (g) Tax Commission Office Visit...
 - (h) Unobtainable Records...
 - (i) Reliance on Competent Tax Advisor...
 - (j) First Time Filer...
 - (k) Bank Error...
 - (l) Compliance History...
 - (m) Employee Embezzlement...
 - (n) Recent Tax Law Change...
- (4)(d) Intentional disregard, evasion, or fraud does not constitute reasonable cause for waiver under any circumstances.

DISCUSSION

At the hearing Petitioners did not dispute that they were Utah residents. Nor did they dispute that they had received wages while residents of Utah. Petitioners rely on the May 9, 2003 IRS letter exempting PETITIONER-1 from withholding for 2003, for the much broader and erroneous position that the IRS had accepted his position that he was exempt from tax liability for 2003 and all subsequent years. As noted by the Division at the hearing, the reason the IRS grants the W-4 withholding exemption letter is if the IRS had refunded all of the withholding to the taxpayer for the prior year and the taxpayer states that he or she expected a refund of all the

withholding in the current year.⁹ Therefore, issuing the withholding exemption relies in part on the representation of the taxpayer regarding what their tax liability will be in going forward in the current year. Additionally, it is the Division's position that the W-4 withholding exemption is valid for only the one year for which it was issued.¹⁰ In this case the W-4 was issued for the 2003 tax year. Petitioners had requested withholding exemptions for subsequent years and they were never granted by the IRS.

In reviewing the information presented, it appears that Petitioner misunderstood the purpose of the IRS's W-4 Exempt from withholding status. Receiving a W-4 Exempt status from withholding means that the Petitioner's employer was not required to withhold taxes from Petitioner's paycheck during 2003. It does not mean that Petitioner was exempt from individual income tax for that year. At the end of the year, based on the income actually received by Petitioner and exemptions/deductions if there was a tax owed, Petitioner was still obligated to file a federal return and pay the tax. Further, granting the W-4 exemption from withholding is not based on a ruling from the IRS that a taxpayer would be refunded all of his withholding, it is based on the assertion from taxpayer that he would be refunded all of his withholding.¹¹

Petitioner's interpretation of the IRS letter and position that his wage income was not subject to tax was based on information he had received and submitted as Exhibit A, which he represented had come from an attorney. In Exhibit A, there is no legal opinion letter signed by the attorney. In fact, the 123 page document is mostly photo copies of various pages and editions of the Code of Federal Regulations or the Federal Register. There are some handwritten notes on the photocopies and then some pages containing meritless assertions, without citations to code or case law. For example there were unsubstantiated claims of a "Fraudulent Creation of Section 39 in the Federal Register, or "The 24th Amendment Abridgment Fraud" and "The Individualized Master File Mass Fraud." The later appears to be an argument that individuals residing in the continental United States are being shown on the Individual Master Files as being in one of the

⁹ See Publication 505 (Rev. December 2002), pg. 10, which states, "You can claim exemption from withholding for 2003 only if **both** the following situations apply. 1) For **2002** you had a right to a refund of all federal income tax withheld because you had no tax liability. 2) For **2003** you expect a refund of all federal income tax withheld because you expect to have no tax liability. It goes on to state on that page, "You may have to file a tax return, even if you are exempt from withholding. See Publication 501, Exemptions, Standard Deductions, and Filing Information, to see whether you must file a return. (Emphasis in the Original.)

¹⁰ Publication 505 (Rev. December 2002), pg. 11.

¹¹ See Publication 505 (Rev. December 2002), pg. 10.

territories of the United States. These assertions are devoid of citation to legal authority or case law. There is no named author or signature for these assertions and they are all unsupported.¹²

Petitioners' position is contrary to the applicable statutory provisions and is without merit.¹³ That they received wages or compensation for their services while residents of Utah was not in dispute. Based on the express terms of the statutes, compensation for services is included in the Utah taxable income regardless of whether the employer was a government employer or private sector employer.¹⁴ Utah may make a state individual income tax assessment whether or not an assessment has been made by the IRS.¹⁵ Utah individual income tax is governed by Utah state statute. Utah Code §59-10-104 imposes a tax on every "resident individual" and Utah Code §59-10-120 on persons who change their status during the year from nonresident to resident. Utah "resident individuals" are subject to state income tax on their "state taxable income." "State taxable income" is defined at Utah Code §59-10-112 (2005) as "federal taxable income" (with

¹² An example of this meritless rhetoric begins at pg. 114 of Petitioner's Exhibit A is a section titled "The 24th Amendment Abridgment Fraud." Petitioner's Exhibit A was what the Petitioners had provided to support their contention that they were not liable for income tax. This argument discusses the 24th Amendment, adopted in 1964. At page 116 of Petitioner's Exhibit A, the anonymous author makes the erroneous and unsubstantiated statement, "The term "failure" at that time could not have been applied to any reasonable extent to sales tax, excises, duties, and imposts. These taxes would be all associated with business operations, and black citizens in black communities in those days were scarcely employed for the most part in anything but strictly labor, or else criminal activity. No disparagement. Just fact." This is a sample of the argument Petitioners relied on to support their position.

¹³ Rev. Rul. 2006-18 which addresses the IRS's position on similar claims and holds, "Federal income tax laws do not apply solely to federal employees and persons residing in the District of Columbia, or federal territories and enclaves, and any contrary contention is frivolous. The terms "employee" and "wages" as used by the Internal Revenue Code apply to all employees, unless specifically exempted by the Internal Revenue Code. The income tax withholding provisions do not affect whether an amount is gross income."

¹⁴ See **United States v. Mann**, 884 F.2d 532 (10th Cir. 1989). In that case, Mann offered many theories as to why he was not required to file income tax returns. The court stated, "His many theories include the asserted beliefs that 1) the United States Supreme Court has declared that the sixteenth amendment applies only to corporations, 2) the Internal Revenue Service (IRS) has no jurisdiction over him, 3) he is not a "person" within the meaning of 26 I.R.C. §7203, 4) wages are not income, 5) federal reserve notes are not legal tender, and 6) the income tax is voluntary." The court in **Mann** responded to these assertions as follows, ". . . each of the views offered by Mann, whether found in his published materials or articulated additionally at trial, falls somewhere on a continuum between untrue and absurd." See also **United States v. Collins**, 920 F.2d 619 (10th Cir. 1990), **cert. denied**, 500 U.S. 920, (1991); **United States v. Lonsdale**, 919 F.2d 1440 (10th Cir. 1990); **United States v. Hanson**, 2 F.3d 942,945 (9th Cir. 1993); **United States v. Studley**, 783 F.2d 934, 937, n. 3 (9th Cir. 1986); **United States v. Sloan**, 939 F.2d 499, 501 (7th Cir. 1991), **cert. den.** 112 S.Ct. 940 (1992); **United States v. Kruger**, 923 F.2d 587, 587-588 (8th Cir. 1991); **United States v. Gerads**, 999 F.2d 1255 (8th Cir. 1993); **United States v. Slater**, 96 F.R.D. 53, 55-56 (D. Del. 1982); and **United States v. Mundt**, 29 F.3d 233,237 (6th Cir. 1994). **Cox V. Commissioner of Internal Revenue**, 99 F.3d 1149 (10th Cir. 1996); **Baker v. Towns**, 849 F. Supp. 775 (D.Utah 1993); and **United States v. Hanson**, 2 F.3d 942 (9th Cir. 1993);

¹⁵ The Utah Supreme Court has addressed this issue in **Nelson v. Auditing Div.**, 903 P.2d 939 (Utah 1995) and **Jensen v. State Tax Commission**, 835 P.2d 965 (Utah 1992).

some modifications and adjustments) as defined in Section 63, Internal Revenue Code. Based on these statutory provisions, state taxable income is income from whatever source derived and specifically includes compensation for services. See Internal Revenue Code at 26 U.S.C. 63 and 61(a). In addition the courts have specifically considered the issue of whether wages are included in federal taxable income and have concluded that wages are taxable income.¹⁶

CONCLUSIONS OF LAW

1. As Petitioners were part-year “resident individuals” of Utah during 2005, a tax is imposed on their “state taxable income” pursuant to §59-10-104 (2005).

2. “State taxable income” is defined as the resident individual’s “federal taxable income.” See Utah Code §59-10-112(2005). Utah Code §59-10-1111) (2005) provides a definition for “Federal Taxable Income” as “taxable income as defined by Section 63, Internal Revenue Code. Under Sec. 63 of the Internal Revenue Code “taxable income” is “gross income.” “Gross income” is “all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees commissions, fringe benefits and similar items; . . .” Section 61, Internal Revenue Code. The wages or compensation that the Petitioners received as for their services from their employers is “taxable income” under Sections 61 & 63, Internal Revenue Code, which means it is “Federal Taxable Income” and, therefore, included in their “State Taxable Income” under Utah Code 59-10-112. That Petitioners received compensation for their services from their employers was not in dispute. As compensation for their services while residents of Utah, it is included in the Utah taxable income.

3. The amount of income the Petitioners received during the years as shown by the information from the IRS was not disputed by Petitioners. Under Utah Code §59-1-1417 Petitioners have the burden of proof to show that the audit was incorrect. The Division’s audit is based on the reported income that was undisputed by the Petitioners and should be upheld.

4. The Division imposed failure to timely file and failure to timely pay penalties under Utah Code Sec. 59-1-401, totaling \$\$\$\$\$. The Petitioners’ position was clearly without

¹⁶The 5th Circuit stated “it is clear beyond peradventure that the income tax on wages is constitutional.” **Stelly v. Commissioner**, 761 F.2d 1113, 115 (1985). See also **Grantor v. C.I.R.**, 739 F.2d 265, 267 (1984) in which the Seventh Circuit stated, “It is well settled that wages received by taxpayers constitute gross income within the meaning of Section 61 (a) of the Internal Revenue Code . . . and that such gross income is subject to taxation.” In **United States v. Koliboski**, 732 F.2d 1328, 1329 fn 1 (1984), the Seventh Circuit stated “the defendant’s entire case at trial rested on his claim that he in good faith believed that wages are not income for taxation purposes. Whatever his mental state, he, of course, was wrong, as all of us already are aware. Nonetheless, the defendant still insists that no case holds that wages are income. Let us now put that to rest: WAGES ARE INCOME.” See also **United States v. Mann**, 884 F.2d 532 (10th Cir. 1989).

merit and similar to position taken up for the purposes of tax evasion. However, the Petitioner testified sincerely that he thought he was correct on his legal position and had his letter from the IRS, which he misinterpreted. The 2005 return would have been a first time Utah filing situation for the Petitioners as they had just moved into the state during that year. These factors weigh in favor and against waiver of the penalties. Based on the first time Utah filing, the 10% failure to file penalty should be waived, but the 10% failure to pay penalty upheld as there is not sufficient cause shown for further waiver.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains the audit of income tax, interest and the 10% failure to pay penalty assessed against Petitioners for the 2005 tax year. The Commission finds reasonable cause for waiver of the 10% failure to file penalty for 2005. It is so ordered.

DATED this _____ day of _____, 2014.

R. Bruce Johnson
Commission Chair

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Robert P. Pero
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. §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 Ann. §59-1-601 et seq. and §63G-4-401 et seq.