19-1468
TAX TYPE: INCOME TAX
TAX YEAR: 2016
DATE SIGNED: 4/3/2020
COMMISSIONERS: J. VALENTINE, M. CRAGUN, R. ROCKWELL, L. WALTERS
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER-1 AND TAXPAYER-2 , Petitioners, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 19-1468 Account No. #### Tax Type: Income Tax Tax Year: 2016 Judge: Nielson-Larios

Presiding:
Aimee Nielson-Larios, Administrative Law Judge

Appearances:
For Petitioners: REPRESENTATIVE FOR TAXPAYERS, Representative, by telephone
For Respondent: RESPONDENT, Auditing Division, in person

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on DATE, 2019, for an Initial Hearing in accordance with Utah Code Ann. § 59-1-502.5. On DATE, 2019, Respondent ("Division") issued a Notice of Deficiency and Audit Change for the 2016 tax year ("Notice of Deficiency") indicating that the Division reduced the Utah AGI on a part-year or nonresident return by $$$$$. The Division disallowed the Taxpayers' claim of a $$$$$ Utah adjustment for an IRA deduction reported on line 27 of the Utah TC-40B form.[1] The Notice of Deficiency shows this change resulted in the following amounts owing:

Tax Year	Audit Tax	Audit Interest	Audit Penalties	Audit Total Due
2016	$$$$$	$$$$$	$$$$$	$$$$$

Audit interest was calculated through DATE, 2019, and continues to accrue on any unpaid balance. The Taxpayers disagree with the disallowance of the $$$$$ Utah adjustment for the IRA deduction reported on line 27 of the Utah TC-40B form.

[1] The bottom line of the 2016 Utah TC-40B form provides the Utah tax amount that flows to line 25, page 2, of the 2016 Utah TC-40.

APPLICABLE LAW

Utah Code Ann. § 59-1-1417(1) states, "In a proceeding before the commission, the burden of proof is on the petitioner [taxpayer] . . ."

Utah Code Ann. § 59-10-116 (2016) imposes Utah individual income tax on a nonresident individual, which tax is calculated using the "nonresident individual's state taxable income."

Utah Code Ann. § 59-10-103(1)(a)(i) and (1)(w)(ii) (2016) define "adjusted gross income" and "state taxable income" for a nonresident individual as follows:

> (a) "Adjusted gross income":
> (i) for a . . . nonresident individual, is as defined in Section 62, Internal Revenue Code . . .
> . . . .
> (w) "Taxable income" or "state taxable income":
> . . . .
> (ii) for a nonresident individual, is an amount calculated by:
> (A) determining the nonresident individual's adjusted gross income for the taxable year, after making the:
> (I) additions and subtractions required by Section 59-10-114; and
> (II) adjustments required by Section 59-10-115; and
> (B) calculating the portion of the amount determined under Subsection (1)(w)(ii)(A) that is derived from Utah sources in accordance with Section 59-10-117 . . .
> . . . .

Utah Code Ann. § 59-10-117 (2016), referenced in § 59-10-103(1)(w)(ii)(B) quoted above, states in part:

> (1) For purposes of Section 59-10-116, state taxable income derived from Utah sources includes those items includable in state taxable income attributable to or resulting from:
> . . . .
> (b) the carrying on of a business, trade, profession, or occupation in this state . . .
> . . . .
>
> (2) For the purposes of Subsection (1):
> . . . .
> (f) if a trade, business, profession, or occupation is carried on partly within and partly without this state, an item of income, gain, loss, or a deduction derived from or connected with Utah sources shall be determined in accordance with Section 59-10-118 . . .
> . . . .

Utah Code Ann. § 59-10-118 (2016) instructs the following, in part:

> (1) As used in this section:
> (a) "Business income" means income arising from transactions and activity in the regular course of a taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition

of the property constitutes integral parts of the taxpayer's regular trade or business operations.

. . . .

(c) "Nonbusiness income" means all income other than business income.

. . . .

(2) A taxpayer having business income that is taxable both within and without this state, shall allocate and apportion the taxpayer's net income as provided in this section.

. . . .

(8) All business income shall be apportioned to this state using the same methods, procedures, and requirements of Sections 59-7-311 through 59-7-320.

26 U.S.C. § 408(a) describes an individual retirement account as follows:

(a) Individual retirement account

For purposes of this section, the term "individual retirement account" means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only if the written governing instrument creating the trust meets the following requirements:

(1) Except in the case of a rollover contribution described in subsection (d)(3) or in section 402(c), 403(a)(4), 403(b)(8), or 457(e)(16), no contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year on behalf of any individual in excess of the amount in effect for such taxable year under section 219(b)(1)(A).

(2) The trustee is a bank (as defined in subsection (n)) or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section.

(3) No part of the trust funds will be invested in life insurance contracts.

(4) The interest of an individual in the balance in his account is nonforfeitable.

(5) The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.

(6) Under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) and the incidental death benefit requirements of section 401(a) shall apply to the distribution of the entire interest of an individual for whose benefit the trust is maintained.

26. U.S.C. § 401(a), (k) describes a § 401(k) plan, stating the following in part:

(a) Requirements for qualification

A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section-

. . . .

(k) Cash or deferred arrangements

(1) General rule

A profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan shall not be considered as not satisfying the requirements of subsection (a) merely because the plan includes a qualified cash or deferred arrangement.

(2) Qualified cash or deferred arrangement

> A qualified cash or deferred arrangement is any arrangement which is part of a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan which meets the requirements of subsection (a)-
> (A) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash;
> . . . .

4 U.S.C. § 114 (last amended in 2006) addresses states' sourcing of individuals' retirement income, stating the following in part:

> (a) No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State . . .

DISCUSSION

The Taxpayers are residents of STATE-1. In 2016, the Taxpayers earned W-2 wages of $$$$$. All of the $$$$$ was earned in Utah. The Taxpayers filed a Utah return as nonresidents, reporting this income. Also in 2016, the Taxpayers contributed $$$$$ to an individual retirement account ("IRA"). The Taxpayers included the $$$$$ as an adjustment to the Taxpayers' Utah income reported on line 27 of the Utah TC-40B form.

The Taxpayers' representative asserted the following at the hearing. The $$$$$ adjustment to Utah income was correctly claimed. A taxpayer must earn compensation to qualify to make a deductible contribution to a traditional IRA, and the Taxpayers' only compensation was the Utah wages of $$$$$. The Taxpayers' other income was from investments and Social Security, which did not qualify the Taxpayers to contribute to a traditional IRA. He argues the IRA deduction was correctly attributed to Utah based on § 59-10-117(1)(b), which states that "state taxable income derived from Utah sources includes those items includable in state taxable income attributable to or resulting from: . . . (b) the carrying on of a business, trade, profession, or occupation in this state." Because the Taxpayers could **not** have made the IRA contribution without the Utah wages, it was his assertion that the IRA deduction was an item described by § 59-10-117(1)(b).

The Taxpayers' representative further asserted the following at the hearing. A taxpayer's contribution to an IRA and a taxpayer's contribution to a 401(k) retirement plan should be treated the same for Utah income sourcing purposes. In general, contributions to a 401(k) retirement plan reduce a taxpayer's state W-2 income. If the Taxpayers' had made $$$$$ in 401(k) contributions, those contributions would have reduced the Taxpayers' Utah taxable W-2 income from $$$$$ to $$$$$. The Taxpayer reported $$$$$ as their Utah AGI after sourcing both the wages and the IRA deduction to Utah. It was his conclusion that this treatment of the IRA deduction is appropriate and equitable.

At the hearing, the Division's representative discussed Utah Code §§ 59-10-116, 59-10-117, and 59-10-118, which are quoted in the Applicable Law Section of this order. Also, the Division's

representative asserted the following at the hearing. He acknowledged that the sourcing of the IRA deduction is not more specifically addressed in the Utah Code. However, he concluded that the Taxpayers' IRA deduction was not derived from Utah sources. Although the Taxpayers earned the Utah W-2 wages from an employer, the Taxpayers did not make the IRA contributions through an employer. Even though the Taxpayers needed earned income to qualify to make the IRA contributions, there was no employer involved in making the IRA contributions.

The Division's representative further asserted the following at the hearing. The Taxpayers claimed state tax benefits for the same IRA deduction on both the Utah and STATE-1 returns. In general, the STATE-1 taxable income is the federal adjusted gross income modified by STATE-1 adjustments. *See* STATE-1 Form 540, Side 2, Lines 13-19 and related STATE-1 Schedule CA. The IRA deduction is included in the calculation of the federal adjusted gross income reported on Form 540, Side 2, Line 13, and the IRA deduction is not added back as a STATE-1 adjustment on Form 540, Side 2, Line 14 or 16, in arriving at the STATE-1 taxable income. Thus, the IRA deduction remains in the STATE-1 taxable income.

The Division's representative addressed the Taxpayers' equitable argument by citing to Utah Administrative Code R865-9I-7(8), which states the following: [2]

> Other income, losses or adjustments applicable in determining total AGI may be allowed or included in the Utah portion of AGI only when the allowance or inclusion is fair, equitable, and would be consistent with other requirements of Title 59, Chapter 10, Individual Income Tax Act, or these rules as determined by the commission.

At the hearing, the Division's representative argued that the Taxpayers' equitable argument was not persuasive. The Taxpayers' treatment of the $$$$$ IRA deduction was not fair or consistent because the IRA has no ties to Utah. In general, an IRA deduction is passive. Passive deductions are treated like passive income. Passive income of a nonresident is not Utah source income; instead, the passive income is sourced to a nonresident's state of domicile. The Taxpayers' IRA deduction and retirement income are passive; both should be sourced to STATE-1, which is the Taxpayers' domicile.

The Division's representative further asserted that the Taxpayers could amend the STATE-1 Schedule S: Other State Tax Credit. The Taxpayers could report the double-taxed income as $$$$$, instead of $$$$$, on their STATE-1 return, and claim an increased "other state tax credit," which carries over to STATE-1 Form 540, Side 3, Line 43.

At the hearing, the Taxpayers' representative disagreed with the Division's arguments about the double tax benefit and the IRA deduction being passive. The Taxpayers' representative asserted that the

[2] In general, R865-9I-7 applies to Utah Code Annotated § 59-10-120, which addresses situations in which "an individual changes the individual's status during the taxable year from resident to nonresident or from nonresident to resident." The Taxpayers did not change their residency during 2016; they were nonresidents for the full year. R865-9I-7 does not apply to the Taxpayers' situation in 2016.

Taxpayers did not claim a double tax benefit. He explained that Schedule CA (540) Line 32 shows the $$$$$ IRA deduction in arriving at the federal adjusted gross income reported on Form 540, Side 2, Line 13, which is used for calculating the STATE-1 taxable income. He further explained that on STATE-1 Schedule S, the Taxpayers claimed double-taxed income of only $$$$$ instead of the full $$$$$ of wages, resulting in a lower "other state tax credit" claimed on their STATE-1 return. Also, he argued that the IRA deduction was **not** passive because the Utah earned income was required for the Taxpayers to make the IRA contribution. He explained that a Utah deduction for the IRA contribution was equitable because allowing the deduction would treat the Taxpayers the same way as a Utah taxpayer living and working in Utah would be treated.

After reviewing the facts presented at the hearing, the parties' arguments, and the applicable state and federal law, an IRA contribution made by a nonresident of Utah is not sourced to Utah under § 59-10-117(1)(b) or (2)(f), which subsections involve "items . . . attributable to or resulting from . . . the carrying on of a business, trade, profession, or occupation in this state." An IRA contribution is not part of the calculation of "business income," as defined in § 59-10-118(1)(a). An IRA contribution is not a "transaction [or] activity in the regular course of a taxpayer's trade or business" for purposes of § 59-10-118(1)(a). The ownership of an IRA account does not "constitute[] [an] integral part[] of the taxpayer's regular trade or business operations," also for purposes of § 59-10-118(1)(a). Furthermore, under federal law an IRA account is associated with an "individual" and is not associated with an "employer." *See* 26 U.S.C. § 408(a).

A nonresident's IRA contribution should **not** be sourced the same as 401(k) contributions. A 401(k) plan is different from an IRA. Unlike an IRA, under federal law, a 401(k) plan actively involves "an employer" and "employee(s)." *See* 26 U.S.C. § 401(a), (k). Thus, a nonresident employee working in Utah could have 401(k) contributions made through a Utah employer and have those contributions reduce his Utah W-2 wages. Unlike 401(k) contributions, there is no employer involvement with contributions to an IRA account.

It is appropriate for Utah to source IRA deductions to taxpayers' residences or domiciles. Under federal law, taxable IRA distributions are sourced to taxpayers' residences or domiciles. *See* 4 U.S.C. § 114. It is appropriate to source the IRA contributions generating the taxable IRA distributions to the taxpayers' residences or domiciles as well.

The Taxpayers have not shown an equitable basis for sourcing the $$$$$ IRA deduction to Utah. In general, nonresident taxpayers cannot claim an IRA deduction for their Utah taxable income, but they can generally claim a credit for taxes paid to another state on the income tax returns of the states where they are domiciled. In this case, the Taxpayers could have claimed a STATE-1 "other state tax credit" calculated using the Utah taxable income without any reduction for an IRA deduction; thereby, receiving

a greater "other state tax credit." The Taxpayers are not entitled to claim the same IRA deduction on both the STATE-1 and Utah returns in arriving at both states' taxable incomes, even if the Taxpayers claim a lower STATE-1 "other state tax credit," calculated using Utah taxable income without any reduction for an IRA deduction.

In summary, the Taxpayers are not entitled to a $$$$$ Utah adjustment for an IRA deduction reported on line 27 of the Utah TC-40B form.

Aimee Nielson-Larios
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains in full the Division's audit assessments for the 2016 tax year. 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, or emailed, 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

or emailed to:
taxappeals@utah.gov

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

DATED this _____day of _____, 2020.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Rebecca L. Rockwell
Commissioner

Lawrence C. Walters
Commissioner

Notice of Payment Requirement: Any balance due as a result of this order must be paid within thirty (30) days of the date of this order, or a late payment penalty could be applied.