BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
) DOCKET NO. 14876
[Redacted])
) DECISION
Petitioners.)
)

On April 14, 2000, the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination to [Redacted] (the petitioners), proposing additional income taxes and interest for the taxable years 1996, 1997, and 1998 in the total amount of $3,105. The petitioners filed a timely protest and petition for redetermination. A telephone hearing was held on December 13, 2000, at 10:00 a.m. The Tax Commission, having reviewed the file, hereby issues its decision.

Although several adjustments were made to the petitioners' income tax returns, the only issue protested by the petitioners is the auditor's treatment of an income distribution from a trust as Idaho source income.

FACTS

For tax years 1996 through 1998, the petitioners, who are Wyoming residents, filed Idaho nonresident individual income tax returns and reported capital gain and interest income relating to the installment sale of Idaho real property as well as a portion of their farm income, as Idaho source income. The petitioners also received a distributive share of income from a partnership, that was transacting business in Idaho, as well as an income distribution from a trust that had filed as an Idaho resident trust for tax years 1996, 1997, and 1998. The petitioners did not treat the distributive share of partnership income or the income distribution from the trust as Idaho source income on the petitioners' 1996, 1997, and 1998 nonresident Idaho income tax return.

Upon audit, the auditor treated the partnership income and the income distribution from the trust as Idaho source income.

The petitioners agree with the auditor's treatment of the partnership income but disagree with the treatment of the trust's income distribution since the majority of the income distribution was interest income on a contract from the sale of land located in Wyoming. The petitioners maintain that "what Idaho is attempting to do is wrong and would violate the United States Constitution." The petitioners contend that "it is surprising that Idaho, which in several contexts recognizes that the location of real estate determines the responsibility for paying income taxes, would try to claim that Wyoming residents with an interest in Wyoming property would be required to pay taxes to Idaho on the sale of the property."

ANALYSIS

As the Idaho Supreme Court pointed out in Blangers v. Commissioner, 114 Idaho 944, 948 (1988), "the most significant evolution that has occurred in the decisions of the Supreme Court is the development of the requirement that there be a sufficient nexus between the presence, property or activities of the nonresident and the state attempting to impose the tax." Given the record before the Tax Commission, it appears that there is sufficient nexus between the petitioners and the state of Idaho to allow Idaho to impose a tax on the petitioners. Furthermore, there is no claim before the Tax Commission that the activity of the petitioners is not sufficiently connected to Idaho to justify a tax. As such, the Tax Commission will turn its attention to the auditor's treatment of the income distribution from the trust as Idaho source income.

The determination of whether or not the trust's income distribution is from an Idaho source is found in Idaho Code Section 63-3026A and Idaho Income Tax Administrative Rule 261 (Rule 261). Idaho Code Section 63-3026A reads, in pertinent part:

63-3026A. Computing Idaho taxable income of part-year or nonresident individuals, trusts and estates. - (1) For nonresident individuals, . . . the term "Idaho taxable income" includes only those components of Idaho taxable income as computed for a resident which are derived from or related to sources within Idaho. . . .

(2) . . . .

(3) For the purposes of subsections (1) and (2) of this section:

(a) Income shall be considered derived from or relating to sources within Idaho when such income is attributable to or resulting from:

(i) . . . .

(ii) . . . .

(iii) . . . .

(iv) A resident estate or trust;

(v) A nonresident estate or trust to the extent the income and deductions of the nonresident estate or trust were derived from or related to sources within this state; . . .

Rule 261 provides that:

261. INCOME FROM ESTATES AND TRUSTS (Rule 261). Section 63-3026A(3), Idaho Code. All income of an estate or trust distributed or distributable to a nonresident beneficiary is income derived from or related to sources within Idaho if the estate or trust is treated as a resident pursuant to Rules 034 and 035 of these rules. If the estate or trust is treated as a nonresident, only those items of income, gain, loss and deduction of the estate or trust that are derived from or related to sources within Idaho are Idaho source income of the beneficiary.

Accordingly, under Idaho law, all income of a trust is considered Idaho source income if the trust is a resident trust. The determination of whether or not a trust is a resident trust or a nonresident trust is found in Idaho Income Tax Administrative Rule 035 (Rule 035) which states that:

035. TRUSTS -- RESIDENCY STATUS (Rule 035).

01. Resident Trusts. A trust is treated as a resident trust if three (3) or more of the following conditions exist:

a. The domicile or residency of the grantor is in Idaho;

b. The trust is governed by Idaho law;

c. Trust property is located in Idaho;

d. The domicile or residency of a trustee is in Idaho;

e. The administration of the trust takes place in Idaho. Administration of the trust includes conducting trust business, investing assets of the trust, making administrative decisions, record-keeping and preparation and filing of tax returns.

> 02. Nonresident Trusts. If the trust does not qualify as a resident trust, it is treated as a nonresident trust. The tax liability of a nonresident trust is computed in the same manner as a nonresident individual.
>
> 03. Residency Status of a Trust. For purposes of determining the residency status of a trust, no distinction is made between inter vivos trusts and testamentary trusts, or between revocable trusts and irrevocable trusts.

Although the Idaho Supreme Court has not addressed the constitutionality of treating all income of a resident trust as being subject to Idaho taxation, other state courts have addressed this issue with respect to their state. For example, the Missouri Supreme Court in Swift v. Director of Revenue, 727 S.W.2d 880 (Mo. 1987) (en banc), provides an analysis of the constitutional limitations on state taxation of "Resident Trusts." The Swift Court was confronted with testamentary trusts created under the will of a Missouri resident. The trusts, only connections with Missouri were Swift's domicile and death in Missouri and the creation and funding of the testamentary trusts through the probate administration of Swift's estate. The trustees, the beneficiaries, the trust property, and the administration of the trusts were in Illinois. The Swift Court held that:

> Missouri law is providing no present benefit or protection to the subject trusts, their beneficiaries, trustees, or property. We hold, therefore, that the State of Missouri does not have a sufficient connection with the subject trusts to permit the imposition of a Missouri income tax under the Fourteenth Amendment or art. I, § 10.

Id at 882. Additionally, the Swift Court, in determining that sufficient nexus did not exist, considered the following criteria (which is similar to the criteria found in Idaho's Rule 035):

> [W]e consider six points of contact: (1) the domicile of the settlor, (2) the state in which the trust is created, (3) the location of trust property, (4) the domicile of the beneficiaries, (5) the domicile of the trustees, and (6) the location of the administration of the trust. For purposes of supporting an income tax, the first two of these factors require the ongoing protection or benefit of state law only to the extent that one or more of the other four factors is present.

Id. Since only the first two points existed, the Swift Court did not find the testamentary trusts to be "Resident Trusts."

In District of Columbia v. Chase Manhattan Bank, 689 A.2d 539, 540 (D.C. App. 1997), the Appellant Court, in determining that there was no violation of the due process clause, held that the District of Columbia could "tax the annual net income of a testamentary trust created by the will of an individual who died while domiciled in the District, when the trustee, trust assets, and trust beneficiaries are all presently located outside the District." Furthermore, the Appellant Court noted that "in all relevant respects . . . the scenario in Swift is factually and legally indistinguishable from the present case." Chase Manhattan Bank, 689 A.2d at 545. However, the Appellant Court, in disagreeing with the Swift decision, stated that:

> As we have already indicated, we do not agree that the question whether the District currently provides any benefit to the trust turns on the physical location of certain persons or goods within the District. In the personal jurisdiction context, the District's jurisdiction over the trust itself exists independently of any jurisdiction over the trustees, beneficiaries, or trust assets. The trust resides in the District and certainly benefits from District law, at least to the extent that its very existence depends on District law and the District courts stand ready to adjudicate trust issues. We therefore believe that the District can require such a "resident" trust to pay income taxes in light of the District's role in establishing the trust and the District's willingness to serve as a judicial focal point for litigation involving the trust.

Chase Manhattan Bank, 689 A.2d at 546.

A similar ruling was made in Chase Manhattan Bank v. Director of Revenue, 733 A.2d 782 (Conn. 1999). In this case, the Connecticut Supreme Court was confronted with the following facts:

> It is undisputed that the plaintiff, acting as trustee, did not maintain any presence and was not a domiciliary or a resident of Connecticut, and that no asset of any trust was located in Connecticut in 1993. No aspect of trust administration was conducted in Connecticut in 1993, and except for this proceeding and the probate proceedings delineated later in this opinion, the plaintiff, as trustee, has not been the subject of any judicial or administrative proceeding in any Connecticut forum. The assets of all of the trusts for 1993 consisted solely of

> cash and securities held in accounts of the plaintiff as trustee in New York. None of the trusts earned any income derived from or connected with the ownership or disposition of any interest in real or tangible personal property, or from a business, trade, profession or occupation carried on by the trust in Connecticut or elsewhere. None of the four testamentary trusts paid any income taxes to any other state for 1993.

Chase Manhattan Bank v. Director of Revenue, 733 A.2d at 787. The Connecticut Supreme Court in Chase Manhattan Bank agreed with the rationale used by the District of Columbia Appellate Court in the District's Chase Manhattan Bank case. The Connecticut Supreme Court held that Connecticut's taxation of all of the income of four testamentary trusts did not violate the due process clause or commerce clause.[1]

Although the various states disagree as to what gives a state the jurisdiction to tax all of a trust's income, the courts agree that a state has the right to treat and tax a trust as a resident provided sufficient nexus exists. The Idaho Supreme Court in Herndon v. West, 87 Idaho 335, 340 (1964), has addressed the imposition of the income tax on residents based upon all of their income. The Court stated, in pertinent part:

> The Supreme Court of the United States has made it clear that a state has the power to tax in relation to a resident's income derived from sources outside the State and that there is nothing in the Federal Constitution to prevent the exercise of such power. Maguire v. Trefry, 253 U.S. 12, 40 S.Ct. 417, 64 L.Ed. 739 (1920); Lawrence v. State Tax Commn. of Miss., 286 U.S. 276, 52 S.Ct. 556, 76 L.Ed. 1102 (1932); New York ex rel. Cohn v. Graves, 300 U.S. 308, 57 S.Ct. 466, 81 L.Ed. 666 (1937). See also: Annot. 87 A.L.R. 380 (1933) and 85 C.J.S. Taxation § 1090, p. 702, n. 55 (1954). The rationale for allowing a state to compute a tax on income earned elsewhere is based on the premise that inhabitants are supplied many services by their state of residence and should contribute toward the support of the state, no matter where their income is earned. In Kopp v. Baird, 79 Idaho 152, 158, 313 P.2d 319, 321 (1957), we discussed a similar problem and quoted from C.J.S. as follows:
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> " '. . . Domicile or residence within the state is a valid basis for the imposition of an income tax by the state. It is competent for a state

[1] All of the testamentary trusts were considered resident trusts under Connecticut law since each of the trusts consisted of property transferred by will of a decedent who at the time of his death was a resident of Connecticut.

> to impose a tax on the income of a resident thereof, or a domestic corporation, whether such income be derived from sources within or outside the state. The enjoyment of the privileges of residence within the state and the attendant right to invoke the protection of its laws are inseparable from responsibility for sharing the costs of government, and a tax measured by the net income of residents is an equitable method of distributing the burden of government among those privileged to enjoy its benefits. The tax is founded on the protection afforded by the state to the recipient of the income in his person, in his right to receive the income, and in his enjoyment of it when received; these are rights and privileges which attach to domicile within the state and the economic advantage realized by the receipt of income and the power to control it bear a direct relationship to the rights and privileges attached to domicile and to the equitable distribution of the tax burden. Neither the privilege nor the burden is affected by the character of the source from which the income is derived . . .' ".

FINDING

Since the petitioners have not shown that the treatment of the trust as an Idaho resident trust was incorrect or that insufficient nexus exists between the petitioners and the state of Idaho to justify an Idaho income tax on the petitioners, the Tax Commission's finding is based upon the presumption that at least three of the five conditions set fourth under Rule 035 have been met; thus, sufficient nexus exists for Idaho to tax the trust as a resident trust.[2] Since the trust is a resident trust, Idaho Code Section 63-3026(A) and Rule 261 require that the income be treated as Idaho source income.

With respect to the petitioners' claim that "what Idaho is attempting to do is wrong and would violate the United States Constitution," the Idaho State Tax Commission does not have the authority to declare an act of the Idaho legislature unconstitutional, <u>Wanke v. Ziebarth Const. Co.</u>, 69 Idaho 64, 75, 202 P.2d 384, 391 (1949); however, the Commission is empowered to

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[2] The record before the Tax Commission shows that the trust is (1) a "simple trust," (2) the administration of the trust is done in Idaho, (3) at least one of the trust's trustees is an Idaho resident, (4) several of the trust's beneficiaries are Idaho residents, (5) the trust has an Idaho employer identification number, and (6) the trust filed an Idaho Form 66 for tax years 1996, 1997, and 1998, on which the box indicating if the trust was a resident trust was marked "yes."

review the facts and circumstances presented in an administrative protest in light of the prevailing constitutional limitations, and to provide its opinions and insights into whether a violation of the federal or Idaho constitution has occurred. Id. Given the record before the Tax Commission, it does not appear that the treatment of the trust distribution as Idaho source income would result in a violation of the federal or Idaho constitution.

WHEREFORE, the Notice of Deficiency Determination dated April 14, 2000 is hereby MODIFIED and, as so modified, is APPROVED AFFIRMED, and MADE FINAL. [3]

IT IS ORDERED and THIS DOES ORDER the petitioners to pay the following taxes and interest (calculated through March 31, 2001):

YEAR	TAX	PENALTY	INTEREST	TOTAL
1996	2,144		593	2,737
1997	149		33	182
1998	244		36	280
Payment made with the filing of amended returns				(1,833)
			TOTAL DUE	1,366

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' right to appeal this decision is enclosed with this decision.

DATED this ____ day of __________________, 2001.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

[3] The Notice of Deficiency Determination was modified for other issues unrelated to the income distribution from the trust.

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _______________, 2001, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]

Receipt No.: [Redacted]

[REDACTED]

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ADMINISTRATIVE ASSISTANT 1