

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 16609
[REDACTED],)	
)	DECISION
Petitioner.)	
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)	

On March 11, 2002, the Tax Discovery Bureau (Bureau) of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (petitioner), asserting income tax, penalty and interest in the amount of \$65,810 for the taxable years 1998 and 1999. The notice advised the petitioner that he could petition the Tax Commission for a redetermination if he disagreed with the deficiency.

On April 23, 2002, the petitioner filed a letter of protest that the Commission treated as a petition for redetermination. The Commission notified the petitioner he could meet with a Commissioner or a designee in an informal conference to discuss the deficiency determined by the Bureau, or, in the alternative, he could submit written information to show why the deficiency should be redetermined.

The petitioner requested an informal conference and he submitted written information in advance of the conference. An informal conference was held on September 24, 2002. At the conference, the petitioner's representative requested additional time to obtain and submit a copy of the petitioner's [Redacted]. The petitioner agreed to submit the [REDACTED] copy within ninety days from the date of the conference, at which time the matter would be deemed fully submitted to the Commission and ready for a decision.

On November 22, 2002, the Commission received a letter from the petitioner. The petitioner stated he had discovered [Redacted] for the taxable year 1999. The petitioner indicated the matter

was fully submitted and that he awaited a decision.

All of the information submitted by the petitioner was placed in and made a part of the Commission's file. The Commission has reviewed the file, is advised of its contents, and now issues this decision. For the reasons set forth below, the Commission affirms the deficiency determined by the Bureau.

This is a nonfiler case. The petitioner lives in [Redacted] Idaho. He did not file [Redacted] or Idaho income tax returns for the taxable years in question. [Redacted] A majority of the income was comprised of pension income as reported on Form 1099-R. As reported by the payors, the petitioner received the following pension payments in 1998: \$199,000 from [Redacted]; \$177,745 from [Redacted]; \$25,000 from [Redacted]; \$19,900 from [Redacted]; \$50,000 from [Redacted]. The petitioner also received wages during the year, as evidenced on the Form W-2 filed by [Redacted], and other miscellaneous income. In total, [Redacted] found the petitioner had received and failed to report approximately \$485,850 of income for the taxable year 1998.

The Tax Discovery Bureau received the audit [Redacted]. The Bureau subsequently contacted the petitioner and stated it appeared the petitioner might be required to file Idaho income tax returns for the years in question. The petitioner responded to the Bureau. He stated he was not required to file a return because his income was derived from nontaxable sources.

The Bureau determined that because the petitioner was an Idaho resident the petitioner's income was taxable and the petitioner was required to file Idaho tax returns. The Bureau subsequently prepared provisional returns for the taxable years 1998 and 1999. The Bureau relied upon the gross income [Redacted] when it prepared a provisional return for the 1998 taxable year. For the taxable year 1999, the Bureau relied upon income information reported on Forms W-2 and 1099 by the persons who made payments or distributions to the petitioner. The Bureau allowed

personal exemptions, standard deductions, and grocery credits when it prepared the provisional returns. Having determined that a deficiency existed, the Bureau issued a Notice of Deficiency Determination on the date and in that amount indicated above.

The petitioner now seeks a redetermination of the deficiency on several grounds. The petitioner asserts he is not required to file Idaho tax returns or otherwise report his income because he believes: (1) he does not have Idaho taxable income because his income does not derive from a “taxable source” listed in Internal Revenue Code § 861; or, alternatively, (2) the Notice of Deficiency Determination is flawed and the asserted tax liability must be canceled on the grounds that: (a) the Commission unlawfully obtained [Redacted] the income information used to determine the tax deficiency; and (b) [Redacted], the deficiency determination is a “naked assessment” (an assessment without a reasonable factual basis).

The petitioner’s stated grounds for redetermination are common tax protestor themes that state and federal courts have rejected time and time again. In Coleman v. Commissioner of Internal Revenue, 791 F.2d 68, Judge Easterbrook penned,

Some people believe with great fervor preposterous things that just happen to coincide with their self-interest. “Tax protesters” have convinced themselves that wages are not income, that only gold is money, that the Sixteenth Amendment is unconstitutional, and so on.

These beliefs all lead--so tax protesters think--to the elimination of their obligation to pay taxes. The government may not prohibit the holding of these beliefs, but it may penalize people who act on them.

The petitioner’s argument regarding the taxability of the income he earned is the type of tax protestor argument addressed by Judge Easterbrook and the courts.

The Sixteenth Amendment provides Congress the power to tax income **from whatever source derived**. Under this broad Constitutional grant of authority, Congress has defined the term gross income to include compensation for services. Section 61 of the Internal Revenue Code

provides that, except as otherwise provided in Subtitle A of the Internal Revenue Code, "gross income means all income from whatever source derived." Section 63 of the Internal Revenue Code defines taxable income as "gross income minus the deductions allowed under this chapter." Idaho incorporated these provisions in its tax laws. Idaho tax law provides:

63-3002. Declaration of intent. It is the intent of the legislature by the adoption of this act, **insofar as possible to make the provisions of the Idaho act identical to the provisions of the Federal Internal Revenue Code** relating to the measurement of taxable income, to the end that the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in the Idaho law; to achieve this result by the application of the various provisions of the Federal Internal Revenue Code relating to the definition of income, exceptions therefrom, deductions (personal and otherwise), accounting methods, taxation of trusts, estates, partnerships and corporations, basis and other pertinent provisions to gross income as defined therein, resulting in an amount called "taxable income" in the Internal Revenue Code, and then to impose the provisions of this act thereon to derive a sum called "Idaho taxable income"; **to impose a tax on residents of this state measured by Idaho taxable income wherever derived** and on the Idaho taxable income of nonresidents which is the result of activity within or derived from sources within this state. All of the foregoing is subject to modifications in Idaho law including, without limitation, modifications applicable to unitary groups of corporations, which include corporations incorporated outside the United States.

Idaho Code § 63-3002 (2002)(Emphasis added). Idaho Code §63-3022 defines the term "taxable income" to mean "'taxable income' as defined in section 63 of the Internal Revenue Code, adjusted as provided" in the Idaho Income Tax Act.

As incorporated in the Idaho Income Tax Act, an individual is subject to Idaho income tax on his income from all sources, unless express federal or state exemptions, adjustments, or limitations apply. The petitioner has not provided any information to establish that his income is exempt under an express federal or state law.

The petitioner argues that the compensation he received is not taxable income because it is

not derived from one of the “taxable sources” listed in Internal Revenue Code §§ 861 and 1461. Sections 861 and 1461 of the Internal Revenue Code (IRC) govern the taxation of income received by nonresident aliens and foreign corporations.

The United States Tax Court reviewed and rejected the petitioner’s argument that a citizen and resident of the United States is taxed only on income received from the sources identified in IRC § 861.

Apparently, petitioner believes that the only sources of income for purposes of section 61 are listed in section 861, that income from sources within the United States is taxed only to nonresident aliens and foreign corporations pursuant to sections 871, 881, and 882, and that section 1461 is the only section of the Internal Revenue Code that makes anyone liable for the taxes imposed by sections 1 and 11.

Section 61(a) defines gross income generally as “all income from whatever source derived,” including, but not limited to, compensation for services and interest. Sec. 61(a)(1), (4). Section 63 defines and explains the computation of “taxable income”. Section 1 imposes an income tax on the taxable income of every individual who is a citizen or resident of the United States.

Habersham-Bey v. Commissioner, 78 T.C. 304, 309 (1982). See also, Aiello v. Commissioner, T.C. Memo. 1995-40.

The federal district court in the eastern district of Wisconsin followed that same analysis in rejecting a taxpayer’s argument that the state of Wisconsin could only tax income derived from sources listed in IRC § 861.

Plaintiff argues further that his remuneration is exempt from taxation under 26 U.S.C. § 861(a)(3)(C)(ii), and thus excludable under 26 U.S.C. § 61 and, by reference, excludable under Wisconsin law. Suffice it to say that if plaintiff wished to avail himself of § 861(a)(3)(C)(ii), he would have to show that his work was done for a foreign office, or an office in a United States possession, of a domestic business entity. He has not alleged this, and it is clear from the record that he performed his work in the State of Wisconsin for Wisconsin employers.

Peth v. Breitzmann, 611 F. Supp 50 (E.D. Wis. 1985). See also Solomon v. Commissioner, T.C. Memo 1993-509 and Dacey v. Commissioner, T.C. Memo 1992-187.

Nonresident aliens and foreign corporations are taxed only on income from certain sources within the United States. Consequently, it is necessary to identify the sources of income (and deductions) for nonresident aliens and foreign corporations. Internal Revenue Code § 861 and the accompanying regulations address the sourcing issue. Internal Revenue Code § 1461 imposes a responsibility for withholding and remitting the tax when paid from one of the taxable sources listed in IRC § 861.

In contrast, U.S. citizens (residents) are taxed on all of their income regardless of where the source is located.

In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.

Treas. Reg. § 1.1-1(b). Consistent with the authority noted above, IRC § 861 does not apply to resident citizens such as the petitioner in this case.

The United States Supreme Court has long recognized that the right to tax is a crucial attribute of state sovereignty. M'Culloch v. Maryland, 17 U.S 316, 428 (1819). "The power to tax rests solely with the legislature, and is subject only to constitutional limitations." Richey v. Indiana Dept. of State Revenue, 634 N.E. 2d, 375 (Ind. Tax Ct. 1994).

The Idaho legislature has enacted specific tax laws that govern the state's income tax. The Idaho income tax return filing requirements are set out in Idaho Code § 63-3030. Idaho Code § 63-3030(a)(1) sets forth the filing requirements for individuals who are residents of this state. A resident individual with gross income in excess of the minimum amount provided in Idaho Code § 63-3030(a)(1) is required to file an Idaho individual income tax return. In addition, an individual

must pay Idaho income tax on his or her taxable income at the rate set forth in Idaho Code § 63-3024.

The statutory authorization for the Commission to determine an individual income tax deficiency and issue a Notice of Deficiency Determination is found in Idaho Code §§ 63-105(1), 63-3044, and 63-3045. Initially, the Commission conducts an audit or investigation to determine whether or not a deficiency exists. A deficiency in tax can result by, among other things, a person failing to file a tax return or failing to report taxable income. When the Commission finds that a person failed to file a tax return or to pay the proper amount of individual income tax, the Commission issues a Notice of Deficiency Determination.

63-3045. NOTICE OF REDETERMINATION OR DEFICIENCY -- INTEREST. (1) (a) If, in the case of any taxpayer, the state tax commission determines that there is a deficiency in respect of the tax imposed by this title, the state tax commission shall, immediately upon discovery thereof, send notice of such deficiency to the taxpayer by registered or certified mail or by other commercial delivery . . .

Idaho Code § 63-3045 (2002). The Bureau followed the procedures set forth in the statute when it issued the Notice of Deficiency Determination to the petitioner.

The information [Redacted] together with the information reported on [Redacted], demonstrate the petitioner was an Idaho resident and received income in excess of the statutory threshold amount that triggers the filing requirement. The Bureau relied upon this information when it prepared provisional returns and determined that the petitioner had a tax deficiency for the taxable years in question.

The petitioner failed to file a return or provide any of the information necessary to determine his filing requirement or his tax liability. The petitioner in this case does not dispute that he received the pension and other compensation indicated on the Forms W-2 and 1099, or that the amount of

compensation reported on the forms are correct amounts.

Instead, the petitioner's representative suggested the Bureau lacks the legal authority to obtain the wage and income information [Redacted]. The petitioner's representative argued that if the information was obtained from [Redacted] without legal authority the information is "tainted" and cannot be used to calculate the petitioner's income tax liability.

The petitioner's assumption is in error. The Bureau properly obtained the wage and income [Redacted] An Idaho State Tax Commissioner, the head of the Idaho State Tax Commission, signed the agreement.

[Redacted] Additionally, the petitioner's argument concerning "tainted" information is a technical argument regarding the admissibility of evidence in a court of law. However, an informal conference conducted by the Tax Commission is not a judicial proceeding. An informal conference is an opportunity for the Commission and the taxpayer to discuss the initial deficiency determined by the Commission's staff and the reasons why taxpayer believes the deficiency should be modified or abated. In this manner, the parties may address and correct any possible errors in the determined deficiency before the determination becomes a tax assessment and thereby avoid the cost of unnecessary litigation.

The applicable Idaho statutes provide that the conference shall be informal. Idaho Code § 63-107 states:

63-107. PROCESS AND PROCEDURE BEFORE STATE TAX COMMISSION. Process and procedure before the state tax commission shall be as summary and simple as reasonably may be, and, as far as possible, in accordance with the rules of equity. Process and procedures before the state tax commission as the state board of equalization under title 63, Idaho Code, and before the state tax commission for redetermination of taxes under section 63-3045 or 63-3631, Idaho Code, are not contested cases within the meaning of chapter 52, title 67, Idaho Code.

Idaho Code § 63-107 (2002). Section 63-3045 of the Idaho Code provides that persons who disagree

with income tax deficiencies determined by the Commission's staff may petition the Commission for a redetermination of the deficiency and request an informal conference. The statute specifically provides the rules of evidence shall not apply.

63-3045. NOTICE OF REDETERMINATION OR DEFICIENCY -- INTEREST. (1) (a) If, in the case of any taxpayer, the state tax commission determines that there is a deficiency in respect of the tax imposed by this title, the state tax commission shall, immediately upon discovery thereof, send notice of such deficiency to the taxpayer by registered or certified mail or by other commercial delivery service providing proof of delivery, whichever is the most cost efficient.

* * *

(2) Following a protest, the taxpayer has the right to a hearing. The purpose of the hearing is to discuss the deficiency determination and the taxpayer's protest with a commissioner or duly authorized representative of the commission. **The meeting shall be held informally and evidence shall be freely admitted regardless of the rules of evidence.**

Idaho Code 63-3045(2002)(emphasis added). The purpose of the informal conference is to determine a person's tax obligations correctly with respect to all available information and without regard to the formalistic rules of evidence that govern court proceedings.

The petitioner also asserted the wage and income information could not be considered in determining his tax obligations because the Forms W-2 and 1099 constitute hearsay evidence that is not admissible in a court of law. As discussed above, the rules of evidence, including the admissibility of certain hearsay information, do not apply.

However, even under the rules of evidence the petitioner's hearsay argument is misplaced for several reasons. First, the information reported on Forms W-2 and 1099, by the persons who made pensions payments and who paid wages to the petitioner, is not hearsay. The term "hearsay" is defined as "a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted." Rule 801(a), Idaho Rules of Evidence. When a party

has manifested an adoption or belief in the truth of a statement, the statement is not hearsay. Rule 801(d)(2)(B). The petitioner does not dispute that he received the pension payments and other compensation reported on Forms W-2 and 1099. Nor has the petitioner disputed the amounts of the payments reported on Forms W-2 and 1099. However, while recognizing that he received the payments, the petitioner asserts that such payments do not constitute taxable income because the payments did not originate from a “taxable source” listed in the federal tax code. Since the petitioner recognizes the truth of the factual matters set forth on the Forms W-2 and 1099, the wage and income information reported on Forms W-2 and 1099 does not constitute hearsay evidence.

Second, making a blanket assertion that the W-2 and 1099 information is “hearsay evidence” does not mean that the information is inadmissible evidence. Both the federal and state Rules of Evidence provide several circumstances in which hearsay statements may be admitted as evidence. See generally Rules 803-806 of the Idaho Rules of Evidence and Rules 803-806 of the Federal Rules of Evidence. Courts have regularly found that Internal Revenue Service forms, such as Forms W-2 and 1099, are admissible as business records and as reports made under the duty of law. See Rules 803(6) and (8) and 1006. See also, United States v. Hughes, 953 F.3d 531 (9th Cir. 1992)(IRS forms summarizing tax information were admissible under public records exception to hearsay rule and forms were probative evidence that, in the absence of contrary evidence, were sufficient to establish that tax notices and assessments were properly made); State v. Barlow, 113 Idaho 573, 746 P.2d 1032 (1987)(Reports made by third party and retained in the regular course of business constituted “business records” admissible over hearsay objection in prosecution for failure to pay tax).

Third, the W-2 and 1099 information would be admissible for certain purposes, such as showing an estimate of income is reasonable and not arbitrary, even if the information was hearsay evidence. The petitioner asserts that, because the deficiency is based on hearsay information, the Commission

must withdraw the deficiency determination for lack of proof. In the petitioner's words, without the W-2 and 1099 information, the deficiency is a "naked assessment."

When seeking a redetermination of the deficiency, the burden is on the petitioner to show that the tax deficiency is erroneous. It is well settled in Idaho that the deficiency determined by the Idaho State Tax Commission is presumed to be correct. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814 (1984); Parsons v. Idaho State Tax Com'n, 110 Idaho 572, 574-575 n.2 (Ct. App. 1986). See also, Welsh v. Helvering, 290 U.S. 111, 115 (1933)(The determination of the Commissioner of Internal Revenue "has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong.").

This presumption of correctness is premised on several different factors, including: (1) the fact that the taxpayer is the complainant in the case and therefore bears the burden of proving his or her complaints against the defendant; (2) the presumption that the taxing authority has acted rationally; and (3) the likelihood that the taxpayer will normally have better access to the relevant records and documents from which to calculate his or her taxable income. United States v. Rexach, 482 F.2d 10, 16 (1st Cir. 1973), *cert. denied* 414 U.S. 1039 (1973). See generally 14 Mertens, The Law of Federal Income Taxation § 50:438.

The presumption of correctness provides an incentive for taxpayers to maintain adequate records and to properly account for their income and expenses. As succinctly stated by the United States Supreme Court in a recent case involving whether or not an Illinois Department of Revenue tax deficiency was entitled to the presumption of correctness in a bankruptcy proceeding:

[F]or the very fact that the burden of proof has often been placed on the taxpayer indicates how critical the burden is, and reflects several compelling rationales: the vital interest of the government in acquiring its lifeblood, revenue; the taxpayer's readier access to the relevant information; and the importance of encouraging voluntary compliance by giving taxpayers incentives to self-report and to keep

adequate records in case of dispute. These are powerful justifications not to be disregarded lightly.

Raleigh v. Illinois Dept. of Revenue, 530 U.S. 15, 20-21 (2000)(emphasis added)(citations omitted).

It is true that the presumption will not apply to a “naked” assessment; that is, an assessment without any foundation whatsoever. Cf. United States v. Janis, 428 U.S. 433, 441 (1976); Erickson v. Commissioner, 937 F.2d 1548, 1551 (10th Cir. 1991)(Some reasonable foundation for the assessment is necessary to preserve the presumption of correctness). In other words, a court will not uphold a tax deficiency based merely on the presumption of correctness where it has been shown that the amount of the deficiency is entirely arbitrary or is based on no rational foundation.

In cases involving unreported income, such as this case involving the petitioner, the taxing authority is given wide latitude in reconstructing or estimating the amount of the unreported income and the presumption of correctness applies unless the reconstruction or estimation technique employed is manifestly irrational or arbitrary. United States v. Fior d'Italia Inc., 536 U.S. 238, 122 S. Ct. 2117 (2002)(The courts have consistently upheld estimates of an individual’s tax liability as long as the method used to make the estimate is a “reasonable one.”); Erickson v. Commissioner, 937 F.2d at 1555 (In testing the minimum requirement of a notice of deficiency, there is only one rule, that there be some rational underpinning.).

A tax deficiency is not “naked” if it is based on a reasonable estimate of the taxpayer’s income, or if the unreported income asserted in the deficiency can be linked back to the taxpayer. Fior d'Italia Inc., 122 S. Ct. at 2122 ; Erickson v. Commissioner, 937 F.2d at 1555; Day v. C.I.R., 975 F.2d 534, 537 (8th Cir. 1992). See generally 14 Mertens, The Law of Federal Income Taxation, §§ 50:441 and 50:442. The Commission is required only to produce a “foundation linking the taxpayer to the alleged income-producing activity” before the deficiency determination will be

accorded its usual presumption of correctness. See Weimerskirch v. Commissioner, 596 F.2d 358, 360 (9th Cir.1979); Blohm v. Commissioner, 994 F.2d 1542, 1549 (11th Cir.1993). The showing required by the Commission is minimal in nature. The courts have held that, although evidence may be “hearsay,” such evidence is admissible for the purpose of showing that the tax deficiency determination was not arbitrary. DiMauro v. Commissioner, 706 F.2d 882, 885 (8th Cir. 1983); Avery v. Commissioner, 574 F.2d 467, 468 (9th Cir. 1978).

The Bureau properly relied upon the wage and income information obtained [Redacted]. Such information provided a reasonable foundation for the deficiency determined by the Bureau. The burden of proving the assessment is erroneous remains with the petitioner.

The petitioner has failed to show the deficiency determined by the Bureau was incorrect. Therefore, the Tax Commission finds the provisional returns to be a fair representation of the petitioner’s taxable income for the taxable years in question and that the amounts shown due on the Notice of Deficiency Determination are true and correct.

WHEREFORE, the Notice of Deficiency Determination dated March 11, 2002, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioner pay the following taxes, penalty, and interest.

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL DUE</u>
1998	\$38,627	\$ 9,657	\$11,292	\$59,576
1999	\$ 5,878	\$ 1,470	\$ 1,290	<u>\$ 8,638</u>
				<u>\$68,214</u>

Interest is calculated through April 1, 2003, and will continue to accrue at the rate of \$6.09 per day until paid.

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

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

DATED this ____ day of _____, 2003.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2003, 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]
