BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 18028
[REDACTED],	)	
	)	DECISION
Petitioner.	)	
	)	

On February 19, 2004, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayer), proposing income tax, penalty, and interest for the taxable years 1993 through 1996 and 1998 in the total amount of $16,839.

On April 21, 2004, the taxpayer's trustee filed a timely appeal and petition for redetermination. The taxpayer did not request a hearing but provided fiduciary income tax returns for the Tax Commission to consider. The Tax Commission, having reviewed the file, hereby issues its decision.

The Income Tax Audit Bureau (Bureau) received information that the taxpayer sold property in Idaho in 1996 and 1999. The Bureau also found that the taxpayer had Idaho rental income as far back as 1993. The Bureau researched the Tax Commission's records and found the taxpayer had not filed Idaho income tax returns for the tax years 1993 through 1996 and 1998. The Bureau sent numerous letters to the taxpayer requesting the filing of Idaho income tax returns. On April 10, 2002, the taxpayer filed returns for the tax years 1993 through 1996. On April 23, 2003, the Bureau received the taxpayer's income tax return for 1998. Since the taxpayer is a trust, any income generated by the trust's assets is flowed through to the beneficiary. The Bureau researched the Tax Commission's records for income tax returns filed by the beneficiary but found that no returns had been filed. The Bureau pursued the filing of income tax returns by the beneficiary but failed to get any response. Therefore, the Bureau adjusted the taxpayer's returns per Idaho Code section 63-3022L(3) and sent the taxpayer a Notice of Deficiency Determination for the tax due on the income that was distributed to the taxpayer's beneficiary.

The taxpayer's trustee protested stating that the taxpayer is a trust and as such any tax liability that might otherwise occur is passed on to the beneficiary, not to the trust. The trustee stated that simple trusts are tax conduits and are not themselves taxed. The trustee stated that the returns the taxpayer prepared and sent to the Tax Commission showed no tax due for the years in question and that the Bureau's determination is in error.

The Bureau referred the matter for administrative review, and the Tax Commission sent the taxpayer a letter giving it two options for having the Notice of Deficiency Determination redetermined. The taxpayer's trustee responded that he did not want to appear for a hearing but would submit additional documents. The trustee stated he would be dealing with an out-of-country entity but that they intended to get copies of the beneficiary's tax returns.

After several months, the trustee provided copies of the beneficiary's income tax returns. The Tax Commission reviewed the beneficiary's returns and found that the beneficiary was also a trust whose trustee was located in [Redacted] in the island nation of [Redacted]. The Tax Commission found that all of the beneficiary's Idaho income tax returns were signed on April 15, 2004. The beneficiary's federal income tax returns were all signed on June 15, 2003, with the exception of the 1997 year which was signed on June 12, 1998.

This second trust identified its sole beneficiary as another trust; the trustee located in [Redacted]. The Tax Commission researched its records for income tax filings for the second trust's beneficiary; however, none were found.

Idaho Code section 63-3022L(3) states if a beneficiary of a trust fails to file an Idaho income tax return reporting its share of income, loss, deduction or credit, or fails to pay any tax due on its return, the trust shall be liable for the tax at the rate applicable to corporations. The Tax Commission's pursuit of the responsible party for the payment of the tax due from the taxpayer's activities in Idaho resulted in identifying more conduits (trusts) in which to flow the income and the tax through. It is well established that a taxpayer has the legal right to minimize his taxes or avoid them totally by any means which the law permits. Gregory v. Helvering, 293 U.S. 465, 469 (1935). However, that right does not allow the taxpayer to construct paper entities to avoid taxation when those entities do not stand on the solid foundation of economic reality. Zmuda v. Commissioner, 79 T.C. 714, 719 (1982), affd. 731 F.2d 1417 (9th Cir. 1984). Only a transaction that has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached" will be recognized for tax purposes. Frank Lyon Co. v. United States, 435 U.S. 561, 583-84, 98 S.Ct. 1291, 1303-304, 55 L.Ed.2d 550 (1978).

In this case, the Tax Commission received returns from the taxpayer reporting that all its income was distributed to its beneficiary and reported on the beneficiary's income tax return. When the Tax Commission finally received the beneficiary's Idaho income tax return, the beneficiary was also a trust. The beneficiary, through administrative costs and an exemption, absorbed $800 of the income distributed by the taxpayer and then distributed the remaining income to its beneficiary. The beneficiary's sole source of income was the income distributed by the taxpayer. The beneficiary trust reported its beneficiary as another offshore trust.

In reviewing the available information, the Tax Commission found that the offshore trusts are nothing more than paper entities structured solely to absorb a small amount of the taxpayer's income and then pass the income to another trust to avoid paying tax. The trusts had no non-tax business purpose for their existence and the entities are wholly without economic substance. Frank Lyon Co. v. United States, supra. Putting aside the question of motive in respect of taxation and fixing the character of the structure by what actually occurred, what was found? The Tax Commission believes that these trusts have no business purpose. They were merely devices which put on the form of a trust to conceal the real objective: a preconceived plan to transfer the income of the taxpayer to the grantor/settlor, however far down it goes. No doubt, new and valid trusts were created, but those trusts were nothing more than a contrivance to the end described. Gregory v. Helvering, 293 U.S. 465, 468 (1935). However, the court stated in Zmuda v. Commissioner, supra at 720:

> When the form of the transaction has not, in fact, altered any cognizable economic relationships, the courts have looked through that form and applied the tax law according to the substance of the transaction. *Markosian v. Commissioner*, 73 T.C. 1235 (1980), [FN15] citing *Furman v. Commissioner*, 45 T.C. 360 (1966), affd. per curiam 381 F.2d 22 (5th Cir. 1967). This rule applies regardless of whether the entity has a separate existence recognized under State law (*Furman v. Commissioner, supra* at 365), and whether, in form, it is a trust, a common law business trust, or some other form of jural entity.

Considering this, the Tax Commission finds that the trusts are mere paper entities wholly without economic substance. In other words, the trusts are shams. Recognizing the multi-tiered trusts would impair the effective administration of the Idaho legislature's tax policies. Zmuda v. Commissioner, supra. Therefore, the trust structure will not be respected for Idaho income tax purposes.

The Tax Commission finds the application of Idaho Code section 63-3022L(3) appropriate in this circumstance. In addition to the tax as assigned per Idaho Code section 63-

3022L(3), the Tax Commission also finds the taxpayer liable for the additions to tax found in Idaho Code sections 63-3045 and 63-3046, interest and penalty.

WHEREFORE, the Notice of Deficiency Determination dated February 19, 2004, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax, penalty and interest:

YEAR	TAX	PENALTY	INTEREST	TOTAL
1993	$1,394	$ 349	$1,219	$ 2,962
1994	191	48	153	392
1995	1,565	391	1,114	3,070
1996	4,276	1,069	2,690	8,035
1998	2,060	515	957	3,532
			TOTAL DUE	$17,991

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

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

DATED this ____ day of ____________________, 2006.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of __________________, 2006, 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]
[REDACTED]

[REDACTED]

Receipt No.

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