

**BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO**

**IN THE MATTER OF THE PROTEST OF
DEWAYNE MALOY
ASSESSMENT 614060**

No. 01-12

DECISION AND ORDER

A formal hearing on the above-referenced protest was held July 16, 2001, before Margaret B. Alcock, Hearing Officer. DeWayne Maloy ("Taxpayer") represented himself. The Taxation and Revenue Department ("Department") was represented by Bridget A. Jacober, Special Assistant Attorney General. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Between 1982 and 1997, the Taxpayer worked for the Hertz Corporation in Texas, Oklahoma and New Mexico.
2. During most of this 15-year period, the Taxpayer was employed in Texas. He worked for a short time in Oklahoma and then moved to New Mexico in October 1994.
3. During his employment with Hertz, the Taxpayer participated in the company's 401(k) retirement plan.
4. The term "401(k)" refers to the section of the Internal Revenue Code that sets out the rules for this type of retirement plan. The terms of the plan allow an employee to defer payment of income tax on the portion of the employee's salary contributed to the plan, as well as on the investment income earned on those contributions. Any payments the employee receives from the plan are taxed as ordinary income at the time of distribution and also may be subject to a 10 percent penalty for early withdrawal.

5. In 1997, the Taxpayer changed jobs and went to work for another employer.
6. As a result of his change in employment, the Taxpayer cashed out the money in his 401(k), which was distributed to him in 1997 while he was a resident of New Mexico.
7. In April 1998, the Taxpayer filed his 1997 federal income tax return, Form 1040. As required by federal law, the income reported included the distribution the Taxpayer received from his 401(k) plan. The federal government subsequently assessed the Taxpayer an additional 10 percent early withdrawal penalty on the distribution.
8. In April 1998, the Taxpayer filed a 1997 New Mexico income tax return, Form PIT-A. As reflected on the PIT-A, New Mexico taxable income is calculated by starting with the taxpayer's federal adjusted gross income and then deducting the taxpayer's federal personal exemptions and itemized deductions.
9. Line 6 of the PIT-A instructs taxpayers to report the federal adjusted gross income shown on Line 32 of their federal Form 1040.
10. The federal adjusted gross income on Line 32 of the Taxpayer's 1997 Form 1040 was \$84,046.85; the federal adjusted gross income the Taxpayer reported on Line 6 of his New Mexico PIT-A was only \$49,186.00.
11. The Taxpayer reduced his federal adjusted gross income when filling out his PIT-A because he did not believe he should have to pay New Mexico income tax on the portion of his 401(k) distribution attributable to contributions made during the period when the Taxpayer lived and worked in Texas and Oklahoma.
12. Texas does not impose a state income tax. Although Oklahoma does impose a state income tax, the Taxpayer did not file a 1997 Oklahoma income tax return to report that portion of his 401(k) distribution attributable to contributions made when he worked in Oklahoma.

13. In 2000, the Department conducted a tape-match which compared the adjusted gross income reported on the Taxpayer's federal income tax return to the adjusted gross income reported on his New Mexico income tax return.

14. Based on the discrepancy between these amounts, the Department issued Assessment No. 614060 to the Taxpayer on July 17, 2000 assessing him an additional \$2,546.00 personal income tax, \$254.60 penalty and \$859.27 interest for tax year 1997.

15. On August 15, 2000, the Taxpayer filed a protest to the Department's assessment.

DISCUSSION

The primary issue to be addressed is whether the Taxpayer is liable for New Mexico income tax on a 401(k) distribution the Taxpayer received while he was a resident of New Mexico, but which was attributable to contributions made during a period when the Taxpayer lived and worked in another state. If it is determined that New Mexico has the right to tax the entire amount of the Taxpayer's 401(k) distribution, a secondary issue is whether the Taxpayer is liable for interest and penalty on the tax due.

Taxation of Retirement Income. The Taxpayer maintains that only the state where a person resides when he earns the income contributed to a 401(k) plan has the right to tax distributions attributable to those contributions. It is the Department's position that the state where a person resides at the time he receives a 401(k) distribution has the right to tax the total amount of the distribution, without regard to the source of the contributions made to the plan.

Payment of New Mexico personal income taxes is governed by the Income Tax Act, Sections 7-2-1, *et seq.*, NMSA 1978. New Mexico is among the majority of states that "piggy-back" or use the federal income tax system as the basis for calculating state income taxes. New Mexico taxable income is calculated by starting with the taxpayer's federal adjusted gross income, deducting the taxpayer's

federal personal exemption and itemized deductions, and certain additional adjustments reflected on Schedule A to the PIT-1. The amount of tax is then drawn from the tax rate table or tax schedule.

When a taxpayer has income that is taxable both within and without New Mexico, Section 7-2-11 NMSA 1978 allows the taxpayer to file a Form PIT-B to allocate and apportion certain categories of income between New Mexico and non-New Mexico sources. The percentage of total income allocated or apportioned to New Mexico is then applied to the tax previously calculated to determine the tax due. Even when a PIT-B is filed, however, there are some categories of income that must be allocated 100 percent to New Mexico, regardless of the source of the income. With regard to retirement income, Department Regulation 3.3.11.13(B) NMAC to Section 7-2-11 NMSA 1978 states as follows:

B. Retirement income of a resident is allocable to New Mexico, regardless of the source of the retirement income, where it is paid from or whether the resident was a resident of New Mexico at the time of the employment which gave rise to the income....

The Department's regulation is based on federal law 4 U.S.C. § 114, which specifically prohibits a state from imposing income tax on the retirement income of an individual who is not a resident or domiciliary of that state. The statute was enacted in 1995 and applies to all payments received from qualified pension plans as defined in § 401(a) of the Internal Revenue Code, which includes plans established under § 401(k) of the Code.

Although Regulation 3.3.11.13(B) NMAC was not adopted by the Department until December 1999, the Department's 1997 personal income tax instructions notified taxpayers of the provisions of 4 U.S.C. § 114 (1996). *See*, page 12 of 1997 Form PIT-1 instructions and pages 2B-3B of instructions for Form PIT B. The instructions for allocating and apportioning income on Form PIT-B specifically directs full-year New Mexico residents that the total amount of pension and

retirement income reported on the resident's federal income tax return must be allocated to New Mexico. The instructions also contain the following note (pages 2B-3B):

NOTE: Effective for retirement income received after December 31, 1995, federal law prohibits any state from imposing an income tax on certain retirement income (primary pension income) of an individual, unless that person is a resident of or domiciled in that state imposing the tax. For example, if you receive a pension from your former California employer, but you have established your domicile in New Mexico, California is barred from attempting to impose their income tax on that retirement income.

Given the clear mandate of 4 U.S.C. § 114 (1996), and the provisions of New Mexico law as reflected in its tax regulations and instructions, there is no basis for the Taxpayer to argue that taxation of his 401(k) distribution is determined by his state of residence at the time contributions were made to the plan. Only New Mexico, the state where the taxpayer resided at the time he received distributions from his 401(k) plan, has jurisdiction to tax that income.

The right of a state to impose income tax on all income received by its residents, including income attributable to activities in other states, is one of long-standing. More than 70 years ago, the United States Supreme Court recognized the rights of the several states "to exercise the widest liberty with respect to the imposition of internal taxes" noting that "states have full power to tax their own people...." *Shaffer v. Carter*, 252 U.S. 37, 51 (1919). In *Lawrence v. State Tax Commission of Mississippi*, 286 U.S. 276 (1932), the Court confirmed that this power includes the right to tax residents on income earned outside the state, holding that Mississippi had the right to tax a Mississippi resident on income earned from services performed on a construction project in the state of Tennessee. As stated by the Court:

The obligation of one domiciled within a state to pay taxes there, arises from the unilateral action of the state government in the exercise of the most plenary of sovereign powers, that to raise revenue to defray the expenses of government and to distribute its burdens equably among those who enjoy its benefits. Hence, domicile in itself establishes a basis for taxation.

286 U.S. at 279. In this case, the Taxpayer was a resident of New Mexico when he received the 1997 distribution from his 401(k) plan, and New Mexico has the right to impose its income tax on the total amount of those distributions.

Assessment of Interest and Penalty. The Taxpayer maintains that even if tax is due on his 401(k) distribution, he should not be liable for interest and penalty because the Department took more than two years to notify him of the deficiency. The Taxpayer's argument is based on a misunderstanding of New Mexico's self-reporting tax system. It is the obligation of taxpayers, who have the most accurate and direct knowledge of their activities, to determine their liability for tax and accurately report that liability to the state. *See*, Section 7-1-13(B), NMSA 1978. There are insufficient government resources available for the Department to continually audit every citizen to determine whether he or she has fully complied with state tax laws. Although the Department performs periodic "tape matches" that compare information reported to the IRS with information reported to New Mexico, there is some delay before the federal tape match information is made available to the Department. Under the Tax Administration Act, the Department has three years from the end of the calendar year in which a tax is due to issue an assessment. Section 7-1-18(A) NMSA 1978. The July 2000 assessment issued to the Taxpayer was well within the statutory limitations period provided by the New Mexico Legislature.

Interest. Section 7-1-67 NMSA 1978 (1996) governs the imposition of interest during the period at issue and states, in pertinent part:

A. If any tax imposed is not paid on or before the day on which it becomes due, ***interest shall be paid*** to the state on such amount from the first day following the day on which the tax becomes due, without regard to any extension of time or installment agreement, until it is paid... (emphasis added).

The legislature's use of the word "shall" indicates that the assessment of interest is mandatory rather than discretionary. *State v. Lujan*, 90 N.M. 103, 105, 560 P.2d 167, 169 (1977). The assessment of interest is not designed to punish taxpayers, but to compensate the state for the time value of unpaid revenues. The reason for a late payment of tax is irrelevant to the imposition of interest. Even taxpayers who obtain a formal extension of time to pay tax are liable for interest from the original due date of the tax to the date payment is made. Section 7-1-13(E) NMSA 1978.

Penalty. Section 7-1-69 NMSA 1978 (1996) governs the imposition of penalty during the period at issue in this protest. Subsection A imposes a penalty of two percent per month, up to a maximum of ten percent:

in the case of failure, due to negligence or disregard of rules and regulations, but without intent to defraud, to pay when due any amount of tax required to be paid...

Taxpayer "negligence" for purposes of assessing penalty is defined in Regulation 3.1.11.10 NMAC as:

- 1) failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances;
- 2) inaction by taxpayers where action is required;
- 3) inadvertence, indifference, thoughtlessness, carelessness, erroneous belief or inattention.

In this case, the Taxpayer's failure to properly calculate his 1997 New Mexico income tax was due to his lack of knowledge of New Mexico law and his erroneous belief that the portion of his 401(k) distribution attributable to income earned in other states was only taxable by those states. The Taxpayer's underpayment of tax also was attributable to his failure to follow the plain language of the Department's income tax forms. Line 6 of Form PIT-A instructs taxpayers to report the federal adjusted gross income shown on Line 32 of their federal Form 1040. Although the federal adjusted gross income on Line 32 of the Taxpayer's 1997 Form 1040 was \$84,046.85, he reported only

\$49,186.00 of this amount to New Mexico. If the Taxpayer did not agree with the instructions on the PIT-A, he should have contacted the Department for clarification or sought the advice of a qualified tax advisor. The Taxpayer's decision to simply ignore the instructions and devise his own method of calculating his New Mexico income tax clearly justifies imposition of the negligence penalty.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely written protest to Department Assessment 614060, and jurisdiction lies over the parties and the subject matter of this protest.

2. New Mexico has the right to require the Taxpayer to pay New Mexico income tax on the total amount of 401(k) distributions he receives while a resident of New Mexico, even when a portion of that income is attributable to contributions made to the 401(k) plan while the Taxpayer was a resident of another state.

3. Pursuant to Section 7-1-67 NMSA 1978, interest was properly assessed against the Taxpayer on the underpayment of his 1997 state income taxes.

4. Pursuant to Section 7-1-69 NMSA 1978, the Taxpayer was negligent in underreporting his 1997 state income taxes and penalty was properly imposed.

For the foregoing reasons, the Taxpayer's protest is DENIED.

DATED July 18, 2001.