STATE OF MAINE
KENNEBEC, ss.

MAINE BOARD OF TAX APPEALS
DOCKET NO. BTA-2014-2

[INDIVIDUAL JOINT TAXPAYERS],

Petitioners

v.

DECISION

MAINE REVENUE SERVICES,

Respondent

I. Introduction

[Individual Taxpayers] (the ["Taxpayer"[1] and "Spouse" or, collectively, the] "Taxpayers") . . . appeal from assessments of individual income tax for tax years [year 2] and [year 3] made against them by Maine Revenue Services ("MRS"). On reconsideration, MRS upheld the assessments of tax and interest in the amount of $[amount], but canceled the assessed penalties. No appeals conference was requested in this matter. Consequently, this decision is based solely upon the written submissions of the parties.

The sole issue raised by the Taxpayers is whether the State of Maine may impose income tax on funds which the Taxpayer converted from an Individual Retirement Account ("IRA") to a Roth IRA in [year 1] while the Taxpayers were residents of [their previous state of residence] prior to their moving to Maine. Based on the evidence submitted, we uphold the assessments as adjusted by MRS in its reconsideration decision.

II. Background

[The Taxpayer] established and contributed to an IRA several years prior to the period at issue while a resident of [previous, non-Maine state of residence ("Prior State")]. An IRA is a

[1] [This appeal concerns the transfer of funds from an IRA owned by one of the Taxpayers to a Roth IRA owned by the same Taxpayer. In this decision, the owner of the IRAs is referred to as the "Taxpayer."]

trust established pursuant to section 408 of the Internal Revenue Code, the purpose of which is to provide income during retirement. Contributions to an IRA are deducted in computing federal adjusted gross income in the year they are made.[2] The contributed funds are invested and the gains are not included in federal adjusted gross income in the year they accrue. However, "any amount . . . distributed out of an individual retirement plan shall be included in gross income . . . ." I.R.C. § 408(d)(1).

In 1997, Congress enacted I.R.C. § 408A, which allows individuals to establish a trust called a "Roth IRA." A Roth IRA differs from an IRA in two significant ways. First, contributions to a Roth IRA may not be deducted from federal adjusted gross income, and second, qualified distributions paid from it are not included in federal adjusted gross income. Thus, the primary difference between the two types of IRA is the timing of income taxes.

Congress provided owners of IRAs the option to convert to a Roth IRA by either: (1) contributing funds distributed from an IRA to a Roth IRA within 60 days of receiving the distribution; (2) making a trustee-to-trustee transfer of funds; or (3) transferring funds to a Roth IRA held by the same trustee.[3] The benefit of converting an IRA to a Roth IRA is to exempt the future receipt of retirement income from taxation. The conversion of an IRA to a Roth IRA by any of the three methods listed above is treated as an IRA distribution,[4] and therefore income, even if the owner of the IRA never actually receives the funds. That income would ordinarily be taxed in the year in which it was actually or constructively received by a taxpayer who, like almost all individual taxpayers, reports on a cash-receipts basis. 26 C.F.R. § 1.446-1(c)(1)(i).

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[2] I.R.C. § 219.

[3] *See* 26 C.F.R. § 1.408a-4 A-1(b)(1) – (3).

[4] "The conversion of an individual retirement plan . . . to a Roth IRA shall be treated . . . as a distribution . . . ." I.R.C. § 408A(d)(3)(C).

Because the amounts converted were likely accumulated over a period of many years prior to conversion, including them in federal adjusted gross income in a single year would result in their being taxed at a higher rate than had the contributions been taxed when contributed. To minimize the tax impact of conversions, section 408A permitted taxpayers to recognize[5] one-half of the conversion amount in [year 2] and the remainder in [year 3] unless they elected to recognize the full conversion amount in the [year 1] year of conversion. *See* I.R.C. § 408A (d)(3)(A)(iii).

In early [year 1], while residing in [Prior State], the Taxpayer converted a portion of her IRA to a Roth IRA and took the remaining amount as a direct cash distribution. This resulted in the Taxpayer's actual receipt of $[amount] and constructive receipt of $[amount] in [year 1] while a resident of [Prior State]. Since the Taxpayer did not elect to recognize the full conversion amount for federal tax purposes in [year 1], she was required to recognize one-half of it in [year 2] and the remainder in [year 3].

Later in [year 1], following completion of the IRA conversion, the Taxpayers moved to Maine, filing both [Prior State] and Maine income tax returns for that year as part-year residents. [Prior State]'s income tax law did not conform to federal income tax law, but instead required the Taxpayers to recognize the full amount of the IRA conversion as taxable income in [year 1]. At the same time, however, Maine income tax law conformed to federal income tax law regarding recognition of income, and by commencing the calculation of Maine taxable income with federal adjusted gross income, the Taxpayers were not required to recognize the conversion amount as income for Maine income tax purposes in [year 1].

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[5] A taxpayer "recognizes" income for federal income tax purposes when it must be reported on a federal income tax return. States that tax income may or may not conform to federal rules regarding when income is recognized.

When the Taxpayers subsequently filed their federal income tax returns for [year 2] and [year 3], they properly recognized [one-half of the conversion amount] as income in each of those years by including those amounts in their federal adjusted gross income. In filing their Maine resident returns for those years, they correctly reported their federal adjusted gross income, but then subtracted the respective portions of the conversion amount in each year. This was done despite the fact that the statutory provision for modifying federal adjusted gross income, 36 M.R.S. § 5122, does not provide for any such subtraction.

Relying on 36 M.R.S. § 5121, which defines a resident's Maine taxable income as his or her federal adjusted gross income modified as allowed by statute, and in the absence of any allowable modification under section 5122, MRS disallowed the Taxpayers' claimed Maine subtraction modifications for [year 2] and [year 3] and issued the subject assessments of Maine income tax, interest, and penalties. As previously stated, MRS upheld the assessment of tax and interest on reconsideration but canceled the assessed penalties. The Taxpayers then timely appealed MRS's decision to this Board for *de novo* consideration. The Taxpayers bear the burden of proving that MRS incorrectly disallowed their subtraction modifications for [year 2] and [year 3].

III. Analysis

The Taxpayers first argue that the law of the state in which income is received governs the future treatment of that income by any other state for income tax purposes. The Taxpayers cite no authority in support of their argument, and the Board is not aware of any such authority. *Cf. Smith v. State Tax Assessor,* 2004 ME 120, 860 A.2d 387 (Maine income tax on IRA distributions received by Maine residents upheld even though such distributions included

amounts contributed to the IRA when the taxpayers were Massachusetts residents and which had been previously taxed by Massachusetts as income earned and received in Massachusetts).

Furthermore, the Constitution of Maine prohibits the Legislature from ceding the power of taxation to any other entity, effectively prohibiting the determination of Maine taxable income by reliance on the income tax laws of another state. Me. Const. art. IX, § 9. See also Me. Const. art. III, §§ 1, 2 and Me. Const. art. IV, § 1. No adjustment to the assessments is warranted on this basis.

The Taxpayers next argue that Maine lacks a sufficient connection with the conversion amount to justify Maine's taxation of it, in violation of the Equal Protection, Full Faith and Credit, and Commerce Clauses of the United States Constitution.

First, Maine's income tax law does not treat different classes of taxpayers unequally in violation of the Equal Protection Clause, nor does it violate the Full Faith and Credit Clause whereas its application to this case does not constitute a refusal to give full faith and credit to a valid judgment or determination of [Prior State]. Also, the Commerce Clause does not apply to this case because Maine's taxation of the conversion amount does not unduly burden interstate commerce. As in the present case, the Law Court in the *Smith* case considered and rejected Equal Protection, Full Faith and Credit, and Commerce Clause challenges to the Maine income tax law, holding that "the [s]tate commits no constitutional violation by relying, for commencement of its taxation calculations, on the federal adjusted gross income reported on the federal tax returns . . . ." *Id.* ¶ 13.

Although not specifically raised by the Taxpayers, their argument does implicate the Constitution's Due Process Clause. The Due Process Clause requires "that there exist some definite link, some minimum connection between a state and the person, property or transaction

it seeks to tax, as well as a rational relationship between the tax and the values connected with the taxing State." *Meadwestvaco Corp. v. Ill. Dep't of Revenue,* 553 U.S. 16, 24, 128 S.Ct. 1498, 170 L. Ed. 2d 404 (2008) (internal quotations omitted).

It is well-established that the Due Process Clause allows a state to tax *all* of a resident's income, from whatever source derived. *See New York ex. rel. Cohn v. Graves,* 300 U.S. 308, 57 S.Ct. 406 (1937); *Oklahoma Tax Comm'n v. Chickasaw Nation,* 515 U.S. 450, 115 S.Ct. 2214 (1995). Courts have also held that a state may tax income earned by a nonresident outside its borders, but which was subsequently received within its borders by a taxpayer who is at that time a resident of the taxing state.[6] The Due Process Clause additionally permits a state to tax nonresidents on "incomes accruing . . . from their property or business within the State, or their occupations carried on therein . . . ." *Shaffer v. Carter,* 252 U.S. 37, 52, 40 S. Ct. 221, 225 (1920). Notwithstanding a state's power to tax a resident upon all income regardless of source, some courts have held that when a taxpayer moves from one state to another the state of new residence may not tax, in the year of the move, the income both earned and received prior to the move.[7] Such was not the case here, as the Maine income tax appealed from was imposed for the two years following the year that the Taxpayers moved from [Prior State] to Maine.

An argument might be made that recognition of income for federal income tax purposes alone provides an insufficient link between the income and a taxing state. *See* Hellerstein & Hellerstein, *State Taxation* ¶ 20.07[2][a][i] (Thomson Reuters/Tax & Accounting, 3rd. ed. 2001, with updates through March 2014) (online version accessed on Checkpoint (www.checkpoint.

[6] *See Rogers v. Chilivis,* 141 Ga.App. 407, 233 S.E.2d 451 (1977), cert. denied, 434 U.S. 891 (1977).

[7] *See, e.g., District of Columbia v. Davis,* 371 F.2d. 964 (DC Cir. 1967), cert. denied, 386 U.S. 1034, 87 S.Ct. 1847 (1967); *Forrester v. Culpepper,* 194 Ga. 744, 22 S.E.2d 595 (1942); *Martin v. Gage,* 281 Ky. 95, 134 S.W.2d 966 (1939); and *Kennedy v. Commissioner of Corps. & Taxation,* 256 Mass. 426, 152 N.E. 747 (1926). Maine applies the same rule, by statute, to apportion a part-year resident's income. *See* 36 M.R.S. § 5224-A.

riag.com) April 18, 2014)). Such an argument, however, would be based solely upon theoretical considerations, argued by analogy from cases involving deferred recognition of gain from the sale of real property rather than from IRA distributions. In the sole case of which the Board is aware involving the same fact pattern as here, the California Franchise Tax Board determined that IRA distribution income was taxable by California where it was received outside California by a California nonresident but was recognized after the taxpayer had become a California resident. *See* Cal. Franchise Tax Bd., Legal Ruling 98-3, October 6, 1998. See also *Johnson v. Dep't of Revenue,* 387 Mass. 59, 65, 438 N.E.2d 1059, 1062 (1982) ("It is the recognition of the gain for Federal tax purposes which is the taxable event on which [Massachusetts income tax law] levied a tax."). Thus, it does not appear that imposition of income tax based solely upon recognition of the income is violative of the Due Process Clause.

The Maine Supreme Judicial Court's longstanding interpretation of section 5121, which defines a resident's Maine taxable income as federal adjusted gross income as modified by statute, is that: (1) modifications to federal adjusted gross income are limited to those specifically set forth in section 5122; and (2) any administrative or judicial inquiry into the nature or composition of the funds included in federal adjusted gross income is foreclosed. *See Tiedemann v. Johnson,* 316 A.2d 359 (Me. 1974); *Green v. State Tax Assessor,* 562 A.2d 1217 (Me. 1989); and *Smith v. State Tax Assessor,* 2004 ME 120, 860 A.2d 387. Thus, in deciding this case, we look solely to the language of sections 5121 and 5122, which does not allow the Taxpayers to subtract the conversion amount from their federal adjusted gross income in computing their Maine income tax liability for the period at issue. Although this application of

the law leads to the unfortunate result that the conversion amount is fully taxed by both [Prior State] and Maine, we have no choice but to apply the law as directed by the Law Court.[8]

IV. Summary of Decision

The assessments of individual income tax for [year 2] and [year 3], as adjusted by MRS in its decision on reconsideration, are hereby upheld.

The Board may, in limited circumstances, reconsider its decision on any appeal. If either party wishes to request reconsideration, that party must file a written request with the Board within 20 days of receiving this decision. Contact the Appeals Office at 207-287-2864 or see the Board's rules, available at http://www.maine.gov/boardoftaxappeals/lawsrules/, for more information on when the Board may grant reconsideration. If no motion for reconsideration is filed within 20 days of the date of this proposed decision, it will become the Board's final administrative action. If either party wishes to appeal the Board's decision in this matter to the Maine Superior Court, that party must do so within 60 days of receiving this decision. During the 60 day period in which an appeal may be filed with the Superior Court, the Taxpayers may contact Maine Revenue Services at 207-624-9725 for the amount of tax, if any, which is currently due, together with any interest or penalties owed. After that 60 day period has expired, Maine Revenue Services will, if any tax, interest, or penalties remain unpaid, contact the Taxpayers with an updated amount of tax, interest, and penalties due at that time.

Issued by the Board on August 8, 2014.

[8] Because the state income taxes imposed by [Prior State] and by Maine were for different tax years, the Taxpayers are not entitled to credit against their Maine income tax liability under 36 M.R.S. § 5217-A for taxes paid to [Prior State]. We also note that double taxation, although unfortunate, is not unconstitutional. *See Shaffer,* 252 U.S. 37, 58, 40 S.Ct. 221, 227 (1920).