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Lee v. Utah State Tax Com'n

Supreme Court of Utah - May 14, 2013 - P.3d - 2013 UT 29

Taxpayers established a qualified plan under Internal Revenue Code section 401. Employer contributions to profit-sharing plans are tax-deductible to the employer at the time of contribution. Plan funds grow tax-free until they are distributed, at which time distributions are taxable to the employee as ordinary income. Here, taxpayer's sole proprietorship contributed funds to the plan. These funds were invested entirely in U.S. government obligations, the interest on which is tax-exempt under 31 U.S.C. section 3124(a).

The distributions that taxpayer received from his qualified plan are taxable as ordinary income, just as any distribution from a retirement or pension plan. At issue here, however, was whether distributions from the plan are tax-exempt because the plan funds were invested in U.S. government obligations.

The court agreed with taxpayer that income received as interest on U.S. government obligations is exempt from state taxation, but the income taxpayer claimed to be exempt was not received as interest on U.S. obligations, but rather as distributions from a qualified Section 401 plan. Thus, the distributions qualify for a tax exemption only if the plan acted as a conduit, allowing the funds to retain their tax-exempt character after distribution.

Taxpayer argued that the tax-exempt character of the interest received by the plan is passed through to them, rendering a portion of their distributions tax-exempt. The Tax Commission argued that the interest loses its tax-exempt nature when the funds are distributed to the beneficiary.

The court concluded that, despite plan funds being invested in U.S. government obligations, distributions from a Section 401 qualified plan are fully taxable. The funds in taxpayer's profit-sharing plan, invested in U.S. government obligations, were exempt from income tax while in the plan. But upon distribution, those funds became plan distributions and could no longer be treated as interest on tax-exempt securities. The distributions from the plan were simply income from a qualified plan, subject to taxation under the Internal Revenue Code and Utah law.