STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **R.J. AND I.E. GABLER** for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1997, 1998 and 1999.	DETERMINATION DTA NO. 818542

Petitioners, R.J. and I.E. Gabler, 21 Arthursburg Road, LaGrangeville, New York 12540, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 1997, 1998 and 1999.

A small claims hearing was held before James Hoefer, Presiding Officer, at the offices of the Division of Tax Appeals, 90 South Ridge Street, Rye Brook, New York on December 14, 2001 at 10:45 A.M. Petitioners appeared *pro se*. The Division of Taxation appeared by Barbara G. Billet, Esq. (Susan Parker).

The final brief in this matter was due by February 15, 2002 and it is this date that commences the three-month period for the issuance of this determination.

ISSUE

Whether the taxable amount of petitioners' IRA distribution and pension and annuity income which was included in Federal adjusted gross income can properly be considered as interest income on obligations of the United States and its possessions and, as such, excluded from New York adjusted gross income pursuant to Tax Law § 612(c)(1).

FINDINGS OF FACT

1. Petitioners herein, R.J. and I.E. Gabler, filed timely New York State personal income tax returns for the years 1997, 1998 and 1999. In computing Federal adjusted gross income on said returns, petitioners reported, *inter alia,* the following amounts of taxable IRA distribution and taxable pension and annuity income:

	1997	**1998**	**1999**
IRA distribution	$1,217.84	$1,277.33	$1,338.00
Pension and annuity income	$29,985.44	$31,967.04	$33,567.00

2. The IRA distributions shown in the above table were paid by the Vanguard Fiduciary Trust Company ("Vanguard") and were reported on forms 1099-R. The pension and annuity income was also paid by Vanguard and, like the IRA distribution, was reported on forms 1099-R.

3. As relevant to this proceeding, petitioners' New York State income tax returns for the three years at issue subtracted $20,000.00 each year from reported Federal adjusted gross income to compute New York adjusted gross income. This subtraction modification, which is commonly known as and will hereinafter be referred to as "the pension and annuity income exclusion," was claimed pursuant to Tax Law § 612(c)(3-a). The pension and annuity income exclusion is, by statute, limited to a maximum of $20,000.00 per year per taxpayer.

4. On October 30, 2000, petitioners filed separate forms IT-201-X, Amended Resident Income Tax Return, claiming that they were entitled to refunds of $782.55, $906.28 and $1,020.00 for the years 1997, 1998 and 1999, respectively. The basis of petitioners' claims for refund for all three years at issue was identical, i.e., that the IRA distribution and pension and annuity income received from Vanguard and included in Federal adjusted gross income consisted entirely of interest income from U.S. government obligations and, as such, was exempt

from taxation in New York pursuant to Tax Law § 612(c)(1). Since petitioners' returns for each of the three years at issue already reported that the first $20,000.00 of IRA distribution and pension and annuity income was excluded from New York adjusted gross income pursuant to Tax Law § 612(c)(3-a), their amended returns only sought a refund of the tax paid on that portion of the IRA distribution and pension and annuity income which exceeded $20,000.00.

5. On March 2, 2001, the Division of Taxation ("Division") issued a Notice of Disallowance to petitioners wherein their claims for refund for all three years were denied in full on the grounds that the IRA distribution and pension and annuity income received during the years in question were gross distributions of principal and not interest income from U.S. government obligations. Petitioners disagreed with the Division's disallowance and this proceeding ensued.

6. During the tax years 1997, 1998 and 1999 petitioners' IRA account and Keogh retirement plan account were continuously invested in the Vanguard Admiral U.S. Treasury Money Market Mutual Fund ("the fund"). There is no dispute that 100% of the income earned by this fund was derived from direct U.S. obligations and that 100% of the assets of the fund were invested in direct U.S. government obligations as of the close of each calendar year. The fund invests in short-term, an average of 65 days, U.S. Treasury bills and other securities backed by the full faith and credit of the U.S. government with little potential to earn a capital gain on their sale. Petitioners received no capital gains from the fund for the years in dispute.

7. The pension and annuity income of $29,985.44, $31,967.04 and $33,567.00, as reported on petitioners' returns for 1997, 1998 and 1999, respectively, was received from the Keogh retirement plan account they maintained with Vanguard, and as noted previously, the

distributions made from this plan were reported by Vanguard on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.

8. For the year 1997, petitioners' Keogh retirement plan account had a beginning balance of $773,624.34 and an ending balance of $795,979.13. The $22,354.79 increase to this account was comprised of the following items:

DATE	ITEM	AMOUNT
1-24-97	lump sum distribution	$(29,985.44)
2-18-97	1996 employer contribution	12,307.00
End of each month	Income dividend	40,033.23
Total		$22,354.79

For the 1998 tax year, petitioners' Keogh retirement plan account had an ending balance of $805,608.41, representing an increase of $9,629.28 over the beginning balance. In 1998, petitioners took a distribution of $31,967.04 from this account (12 monthly distributions of $2,663.92); had a 1997 employer contribution of $1,061.00 which was made on April 14, 1998 and received varying monthly income dividends totaling $40,535.32 for the year.

The ending balance in petitioners' Keogh retirement plan account for 1999 was $809,457.06, an increase of $3,848.65 over the beginning balance. In 1999 petitioners' distributions from the account totaled $33,567.12 (12 monthly distributions of $2,797.26), while they received varying monthly income dividends totaling $37,415.77 for the year.

9. The record herein with respect to the IRA account does not contain the same detail regarding account balances and dividend income earned as compared to the details available concerning the Keogh retirement plan account. The record does disclose that as of December 31, 1998 the IRA account had a balance of $32,115.12 and that the $1,338.13 distribution made from this account in 1999 was accomplished by one annual payment which occurred on some unknown date in January 1999.

10. For each of the three years at issue petitioners elected to take the required minimum distribution from both the IRA account and the Keogh retirement plan account. The required minimum distribution amount was calculated each year by taking the account's closing balance as of December 31 of the preceding year and dividing this amount by petitioner R. J. Gabler's life expectancy factor.

11. The Account Option Profile issued to petitioners by Vanguard indicates that, with respect to the Keogh retirement plan account, petitioners elected to have the income dividends and capital gains reinvested in additional shares. The record does not reflect whether petitioners elected this same option with respect to their IRA account.

12. Information in the record reflects that the yield received on the balance in the Keogh retirement plan account varied on a month-to- month basis. Yield is defined by Vanguard in its Fund Profile as "A snapshot of a fund's interest income. The yield, expressed as a percentage of the fund's net asset value, is based on income earned over the past 30 days (7 days for money market funds) and is annualized, or projected forward for the coming year." There is no evidence in the record before me to show that there is any relationship or correlation between the yield petitioners received from Vanguard and the interest rate, or interest income, generated from the U.S. government obligations.

SUMMARY OF THE PARTIES' POSITIONS

13. Petitioners maintain that the IRA and pension and annuity income distributions they received in 1997, 1998 and 1999 from Vanguard represented interest income on obligations of the United States. In their initial brief, petitioners concede that:

> the "interest income on obligations of the United States" paid to them from their accumulated, pre-1997 capital contributions was derived from Keogh and IRA sources, but the child is not the parent, and being "derived" does not make "interest income on obligations of the United

> States" lose its character and identity, becoming, artificially, Tax Law section 612(c)(3-a) "pension and annuity" income.
>
> It was this currently earned 612(c)(1) "interest income on obligations of the United States," not taxpayers' pre-1997 Keogh and IRA capital contributions, which was paid to them in the aforesaid three years, their Keogh and IRA capital remaining untouched and intact as it was on December 31, 1996.

14. Petitioners also assert that the general rules of construction of documents support their position; that any ambiguity in the law must be construed against the Division and that Tax Law § 607 provides that the language of the Tax Law shall have the same meaning as that of the Internal Revenue Code. Petitioners believe that the Division's position distorts and transmutes the words of Tax Law § 612(c)(1) from their plain and natural meaning and that said position undermines the long established comity between Federal and State governments by taxing interest income on obligations of the United States government.

15. The Division asserts that the distributions petitioners received from their IRA and pension and annuity income accounts were not distributions of interest income from U.S. government obligations, but instead represented gross distributions of principal from each account.

CONCLUSIONS OF LAW

A. A taxpayer's New York adjusted gross income is his or her Federal adjusted gross income with certain modifications either increasing (Tax Law § 612[b]) or decreasing (Tax Law § 612[c]) reported Federal adjusted gross income. In this proceeding there are two subtraction modifications at issue. The first, Tax Law § 612(c)(1), provides that "interest income on obligations of the United States and its possessions" is an allowable modification reducing Federal adjusted gross income to the extent that such interest income was included in Federal gross income. The second modification to be considered is Tax Law § 612(c)(3-a), which, as relevant to this proceeding, provides for the following subtraction modification:

> Pensions and annuities received by an individual who has attained the age of fifty-nine and one-half . . . to the extent includible in gross income for federal income tax purposes, but not in excess of twenty thousand dollars. . . . However, the term "pensions and annuities" shall also include distributions received by an individual who has attained the age of fifty-nine and one-half from an individual retirement account or an individual retirement annuity, as defined in section four hundred eight of the internal revenue code.

B. The primary issue to be decided here is whether the distributions petitioners received during the years at issue from both their IRA account and Keogh retirement plan account represented distributions of interest income on obligations of the United States and its possessions or whether they were distributions of principal from the corpus of each account. For several reasons I conclude that said distributions cannot be considered as interest income on obligations of the United States and its possessions but instead represented distributions from the corpus of each account.

C. Initially, I note that petitioners elected to have the income dividends generated from the Keogh retirement plan account reinvested in the purchase of additional shares. Also, the minimum distribution amounts received each year by petitioners from both accounts were calculated without regard to the income dividends earned by each account. These facts do not support petitioners' position that the interest income earned by each account was merely "passed through" to them and that the distributions retained their identity as interest income on obligations of the United States and its possessions.

Additionally, there is no evidence in the record before me to establish that the yield received by petitioners from Vanguard on both accounts bore any relationship to the interest rate received by Vanguard on the underlying obligations of the United States and its possessions (***see, Nebraska Department of Revenue v. Lowenstein,*** 513 US 123).

While it is undisputed that had petitioners individually invested in these funds that the income generated from said funds would have qualified for the exemption provided for in Tax Law § 612(c)(1), it must be noted that this is not what occurred here. Petitioners chose to utilize pre-tax dollars to fund an IRA account and a Keogh retirement plan account and they received certain tax benefits as the result of this choice. Petitioners made a voluntary decision to fund an IRA account and a Keogh retirement plan account, as opposed to investing these same funds in an individual capacity without the tax benefits afforded them by use of the IRA account and a Keogh retirement plan account, and they cannot now reasonably claim that the distributions received by them from the retirement accounts should be afforded the same tax treatment as the taxpayer who invested individually. Petitioners received a tax benefit at the time the contributions were made into the IRA account and the Keogh retirement plan account and deferred any income tax on the principal and gain generated by the investment until a distribution was taken, while the individual who invests directly into the mutual fund with post-tax dollars receives a tax benefit upon receipt of the income.

It is also noted that the distributions in question were reported by Vanguard on forms 1099-R as taxable IRA and pension or annuity distributions from the respective accounts and were not reported as interest income on Form 1099-INT or dividend income on Form 1099-DIV. Pursuant to Internal Revenue Code § 408(d) and § 72 it is clear that the distributions in question were properly classified as distributions from an IRA and pension or annuity plan for Federal tax purposes and, in accordance with Tax Law § 607, these distributions retain the same classification for New York State income tax purposes.

Finally, I note that for the 1997 tax year petitioners took the required minimum distribution of $29,985.44 in one lump sum on January 24, 1997. The obvious question which comes to mind if petitioners' position is accepted that the distribution represents current year interest income, is how, on January 24, 1997, they could receive $29,985.44 of income which had not yet been earned. The only answer is that they received a distribution from the corpus of the account.

D. The petition of R.J. and I.E. Gabler is denied and the Division's Notice of Disallowance dated March 2, 2001 is sustained.

DATED: Troy, New York
May 9, 2002

/s/ James Hoefer
PRESIDING OFFICER