

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

**IN THE MATTER OF THE PROTEST OF
MANUEL VIGIL TO ASSESSMENT OF 2002
PERSONAL INCOME TAX ISSUED UNDER
LETTER ID I0813917440**

No. 06-21

DECISION AND ORDER

An administrative hearing on the above-referenced protest was held on December 13, 2006, before Margaret B. Alcock, Hearing Officer. The Taxation and Revenue Department (“Department”) was represented by Peter Breen, Special Assistant Attorney General. Manuel Vigil (“Taxpayer”) represented himself. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer was a resident of New Mexico during 2002.
2. For tax year 2002, the Taxpayer received a Form 1099 listing the dividend and capital gain distributions made to the Taxpayer from two Charles Schwab mutual funds.
3. Pursuant to the Taxpayer’s agreement with Charles Schwab, these distributions were not paid to the Taxpayer in cash, but were reinvested in the two funds.
4. The Taxpayer later sold his shares in the Schwab mutual funds for a \$23,000 loss.
5. When the Taxpayer completed his 2002 federal and state income tax returns, he did not include the mutual fund distributions reported to him on Form 1099.

6. The Internal Revenue Service subsequently assessed the Taxpayer for additional federal income tax on the 2002 distributions he received from the Schwab mutual funds.

7. On July 24, 2006, the Department assessed the Taxpayer for additional New Mexico income tax, plus penalty and interest, on the 2002 distributions he received from the Schwab mutual funds.

8. On September 28, 2006, pursuant to a retroactive extension of time granted by the Department, the Taxpayer protested the Department's assessment.

DISCUSSION

The issue to be determined is whether the Taxpayer is liable for the Department's assessment of New Mexico personal income tax on the 2002 distributions from the Taxpayer's Charles Schwab mutual funds. There is a statutory presumption that any assessment of tax made by the Department is correct. NMSA 1978, § 7-1-17(C). *See also, MPC Ltd. v. New Mexico Taxation & Revenue Department*, 2003 NMCA 21, ¶ 13, 133 N.M. 217, 62 P.3d 308. Accordingly, it is the Taxpayer's burden to present evidence and legal argument to show that he is entitled to an abatement, in full or in part, of the assessment issued against him.

Payment of New Mexico personal income tax is governed by NMSA 1978, §§ 7-2-1, *et seq.* New Mexico is among the majority of states that use the federal income tax system as the basis for calculating state income taxes, beginning with a taxpayer's federal adjusted gross income. *See, Holt v. New Mexico Department of Taxation and Revenue*, 2002-NMSC-034 ¶¶ 8, 9, 133 N.M. 11, 59 P.3d 491. Although 26 U.S.C. § 61(a) of the Internal Revenue Code defines

gross income to include both dividends and gains from dealings in property, the Taxpayer maintains that he does not owe federal or state income tax on the dividend and capital gain distributions reported to him by Charles Schwab. The Taxpayer argues (1) that he lost money on the two mutual funds and should not have to pay tax on a loss; and (2) that he never received the distributions because they were reinvested in the funds. These arguments are based on a misunderstanding of the way in which mutual funds operate and the nature of the distributions reported to the Taxpayer.

A mutual fund, also known as a regulated investment company, is generally treated as a pass-through entity for tax purposes. *See*, 26 U.S.C. §§ 851-852. As long as a mutual fund distributes at least 90 percent of the dividend and capital gain income generated from the fund's investment activity, the fund pays no tax on this income. Instead, the fund's shareholders are required to report the distributions on their own tax returns. As explained in Rev. Rul. 89-81, 1989-1 C.B. 226, this pass-through tax treatment allows small investors to pool their resources and obtain a professionally managed and diversified investment portfolio without paying the penalty of a second layer of tax, which would normally apply if the mutual fund were taxed as a regular corporation. In effect, each shareholder pays tax on his pro rata share of the mutual fund's income as if the shareholder, rather than the fund, had invested in the various stocks and bonds held in the fund.

In this case, the Form 1099 the Taxpayer received from Charles Schwab set out the 2002 dividend and capital gain income attributable to the investments held in two Schwab mutual funds. As a shareholder in the funds, the Taxpayer was required to report and pay tax

on this income. The fact that the overall value of the funds' assets dropped and the Taxpayer suffered a loss does not relieve the Taxpayer of this liability. As a simplified analogy, assume that the Taxpayer owned 100 shares of Stock A, which he purchased for \$3,000; that the Taxpayer received a \$45 stock dividend during 2002; and that the Taxpayer subsequently sold the stock for \$2,700, resulting in a loss of \$300. The fact that the Taxpayer lost money on his sale of Stock A would not relieve him of the obligation to pay income tax on the \$45 dividend he received during 2002. Similarly, the fact that the Taxpayer lost money on his overall investment in the Schwab mutual funds does not relieve him of his obligation to pay income tax on his pro rata share of the funds' income distributions.

Nor does the fact that the distributions were reinvested in the funds—rather than paid to the Taxpayer in cash—affect the Taxpayer's income tax liability. Pursuant to 26 C.F.R. § 1.451-2(a) of the federal income tax regulations:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions....

Here, the 2002 Form 1099 admitted into evidence establishes that the Taxpayer's distributive share of mutual fund income was credited to his account with Charles Schwab. At the Taxpayer's direction, that money was then reinvested through the purchase of additional shares, which served to increase the Taxpayer's holdings in the Schwab funds. As noted in *Furstenberg v. Commissioner*, 83 T.C. 755, 791 (1984) (quoting *Loose v. United States*, 74

F.2d 147, 150 (8th Cir.1934)), income is received by cash basis taxpayers “when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession.” In this case, the Taxpayer elected not to take his distributions in cash, but to have them reinvested. This voluntary action on the part of the Taxpayer cannot be treated as a restriction or limitation on his use of that money or relieve him of his obligation to report it as income on his 2002 personal income tax returns.

CONCLUSIONS OF LAW

A. The Taxpayer filed a timely, written protest to the assessment issued under Letter ID 10813917440, and jurisdiction lies over the parties and the subject matter of this protest.

B. The 2002 mutual fund distributions reported to the Taxpayer on Form 1099 are subject to New Mexico personal income tax.

C. The Taxpayer’s subsequent loss on his sale of shares in the mutual funds does not affect his liability for tax on distributions from the funds.

D. The Taxpayer’s decision to reinvest his mutual fund distributions, instead of taking them in cash, does not affect his liability for tax on the distributions.

For the foregoing reasons, the Taxpayer’s protest IS DENIED.

DATED December 18, 2006.