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Governor

David Briant
Director

PRIVATE TAXPAYER RULING LR16-005

May 17, 2016

The Department issues this private taxpayer ruling in response to your letter requesting a ruling on behalf of ***, a self-employed nonresident attorney performing legal services in this state.

Issue

Is a self-employed nonresident attorney subject to Arizona's income tax on income from activities performed at his Arizona home while living in Arizona, even though Taxpayer's business does not provide legal services to Arizona residents and the State of Washington taxes the gross revenue of the business without reference to any income tax levied by the State of Arizona?

Ruling

Taxpayer is performing legal services while physically present in this state. Taxpayer's income generated from performing legal services is income from an activity carried on in this state and therefore is attributable to sources within this state. Arizona Revised Statutes "A.R.S." § 43-104(9). Once Taxpayer physically availed himself to Arizona by living and working in Arizona several months a year it more than satisfied any nexus requirements under the due process clause or interstate commerce clause of the United States Constitution. Under Arizona Administrative Code "A.A.C." R15-2C-601(D)(4)(g)(iii) non-resident attorneys must include in gross income as income from sources within this state the entire amount of fees or compensation for services performed in this state on behalf of their clients. As such, Taxpayer's compensation for services performed in this state on behalf of his clients is includable in Taxpayer's Arizona gross income.

Arizona allows a credit for net income taxes paid to another state. Taxpayer is a resident of Washington. Washington does not impose a net income tax but rather imposes a Business and Operating tax based on the gross receipts of the business. As such, Taxpayer is not entitled to claim Arizona's credit for net income taxes paid to another state.

Statement of Facts

*** (hereinafter "Taxpayer") is a self-employed nonresident attorney licensed to practice law in the State of Washington. Taxpayer's business maintains an office in a suburb of *** and has a mailing address in ***. Taxpayer lives in Arizona several months a year, however

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Taxpayer is not licensed to practice law in Arizona and his business does not represent clients in Arizona. The State of Washington does not impose a net income tax upon individuals; rather it imposes a Business and Occupation Tax (hereinafter "B&O Tax") on businesses based upon gross revenue, not net income. While Taxpayer is in Arizona, the clients he represents on behalf of his business do not know Taxpayer is in Arizona. Taxpayer uses a telephone number associated with the ***, Washington area and the same email address and email signature as he does while he is in the State of Washington. Taxpayer does not meet with clients while he is in Arizona.

Taxpayer Position

Taxpayer argues his business income is not "income derived from or attributable to sources within this state" under A.R.S. § 43-104(9) because his clients are not located in this state. Taxpayer further argues A.A.C. R15-2C-601(D)(4)(g)(iii) only applies if Taxpayer's representation of his clients is associated with any interests which his clients may have in Arizona. Taxpayer also argues that both the due process clause and interstate commerce clause of the United States Constitution preclude Arizona from levying an income tax on Taxpayer.

Due Process Clause

The United States Supreme Court has interpreted this Due Process Clause to limit the power of states to, among other things, levy taxes upon businesses that have little or no association with a particular state. In *Exxon Corp. v. Wisconsin Dep't of Rev.*, 447 U.S. 207, 219-220 (1980), the U.S. Supreme Court stated the following:

"The Due Process Clause of the Fourteenth Amendment imposes two requirements for such state taxation: a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'"

Taxpayer's argument that subjecting his business to Arizona's income tax fails to meet the rational relationship prong of the due process clause may be summarized as follows. No part of the value of Taxpayer's business is attributable to Arizona. Arizona law prohibits Taxpayer's business from providing legal advice to, or representing, most people who are within Arizona's jurisdiction. Taxpayer's office is located in his home state of Washington and none of his clients are located in Arizona. Taxpayer is licensed to practice law by his home state. Taxpayer's business does not have a standalone office or clients in Arizona and therefore the "intrastate values" of the business in Arizona are zero.

Taxpayer further argues Arizona does not provide a marketplace of clients to whom Taxpayer's business can provide legal services nor does it provide courts that have jurisdiction to enforce judgments against Taxpayer's business's clients, who live in another

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state, on behalf of Taxpayer's business. Finally, Taxpayer argues Arizona does not provide police, fire protection, or other services to his business.

Commerce Clause

The U.S. Supreme Court has specifically clarified the applicability of the Commerce Clause to state tax laws that potentially affect interstate commerce in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), via the following four-requirement test:

"These decisions have considered not the formal language of the tax statute but rather its practical effect, and have sustained a tax against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."

Taxpayer's argument that subjecting him to Arizona income tax is in violation of the commerce clause may be summarized as follows. Taxpayer's business does not have substantial nexus with Arizona because it lacks economic nexus with Arizona. Taxpayer's business is not fairly apportioned because taxing nonresidents on their Arizona sourced income under A.R.S. 43-1091 is not internally consistent. Subjecting Taxpayer's business to Arizona income tax discriminates against interstate commerce because it creates undue burdens and because Arizona only allows credits for net income taxes and not gross receipts tax such as Washington's B&O tax. Finally, Taxpayer's business receives little, if any, of the traditional benefits that a state provides to businesses in return for taxing those businesses, (e.g., an economic market, court jurisdiction to enforce judgments against delinquent customers or clients, police and fire protection) and therefore Arizona's tax is not fairly related to the services provided by the state.

Discussion

Arizona residents are taxable on their worldwide income. A.R.S. § 43-1001(2). Arizona nonresidents are taxable only on their Arizona sourced income. A.R.S. § 43-1091. Under the United States Constitution powers not delegated to the federal government are reserved for the States. *U.S. Const.* amend. X. To the extent Arizona's tax laws do not conflict with the U.S. Constitution and federal law its taxing rules are supreme within its boundaries. In order for Arizona to subject Taxpayer to its income tax it must satisfy both the due process clause and the commerce clause of the United States Constitution.

Due Process Clause

In order for the State of Arizona to subject Taxpayer to taxation, Taxpayer must have some minimum connections with the state and the tax must be rationally related to the values

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connected to the taxing state. In this case, Taxpayer is physically present in this state which more than satisfies the minimum connection prong of the due process clause. The second prong of due process clause, that the tax be rationally related to the taxing state, is a low constitutional bar that is easily met here. Taxpayer benefits from Arizona infrastructure such as roads, modem and telephone lines as well as 911 services for fire and police protection in both his personal and business capacity. It is perfectly rational, and indeed the norm for states in this country, to tax nonresidents on services performed while physically in that state.

Commerce Clause

In order for the State of Arizona to subject Taxpayer to income taxation under the Commerce Clause it must satisfy the four part test articulated in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

1. "Substantial nexus with the taxing state"

In *Complete Auto Transit*, the Court found that the substantial nexus requirement was satisfied because the business had a physical presence in that state. Taxpayer and his business have a physical presence in Arizona and therefore have substantial nexus with Arizona.

2. "Fairly apportioned"

Arizona levies a net income tax and provides a credit for net income taxes paid to another state or country. Arizona's credit for income taxes paid to another state statute is internally consistent. If every state had a state level net income tax and provided a credit for net income taxes paid to another state (like Arizona) it would not discriminate against interstate commerce. Arizona's tax is also externally consistent in that it only seeks to tax nonresidents on their income derived from Arizona sources. Arizona is only subjecting Taxpayer to taxation for work performed while physically present in this state. Any legal services performed when Taxpayer is in Washington is not subject to Arizona income tax.

3. "Does not discriminate against interstate commerce"

Taxpayer is performing legal services in Arizona while living in Arizona. If Taxpayer is subject to both Washington's B&O tax and Arizona's individual income tax it does not result in double taxation because the nature of the two taxes are different. Arizona imposes a net income tax while Washington's B&O tax is based on gross receipts calculated without regard to Taxpayer's gross profit or income. If Washington imposed a net income tax there would be a credit on either the Washington income tax return or the Arizona income tax return. Arizona does not impose an undue burden on taxpayers. Pursuant A.R.S. § 43-301 Arizona's income tax filing requirement threshold is Arizona adjusted gross income of \$5500 for single taxpayers and \$11,000 for married taxpayers. Pursuant to A.R.S. § 43-403

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Arizona does not require Arizona income tax withholding until an employee works in this state for 60 days. Arizona is not discriminating against interstate commerce by subjecting Taxpayer to its income tax.

4. Fairly related to the services provided by the State

Arizona's income tax is fairly related to the services provided by the State. Taxpayer benefits from Arizona infrastructure such as roads, modem and telephone lines as well as 911 services for fire and police protection in both his personal and business capacity while physically working in Arizona.

Income Derived from or Attributable to Sources within this State

A.R.S. § 43-104(9) provides "Income derived from or attributable to sources within this state" includes income from tangible or intangible property located or having a situs in this state and income from any activities carried on in this state, regardless of whether carried on in intrastate, interstate or foreign commerce.

Taxpayer is performing legal services in Arizona while living in Arizona. Taxpayer argues since the clients are in another state the income is not attributable to sources within this state. Under this sourcing theory any time services were performed in Arizona, but the client was an out of state resident, the income (having to be sourced somewhere) would be sourced out of state. Such a theory would create an absurd result. An example might be an Arizona accountant preparing a partnership return and corresponding K-1's for several nonresident clients. Taxpayer would seem to argue the Arizona accountant should source his tax preparer fee not to Arizona, but rather to a nonresident state where the preparer's only connection is that his client lives there. The geographic location of Taxpayer's clients is not relevant for Arizona income tax purposes. Taxpayer's income generated from performing legal services is income from an activity carried on in this state and therefore is attributable to sources within this state.

Arizona Law

A.R.S. § 43-1091 provides in the case of nonresidents, Arizona gross income includes only that portion of federal adjusted gross income which represents income from sources within this state.

Arizona's statutes do not define the exact phrase "income from sources within this state"; however, A.R.S. § 43-104(9) defines "income derived from or attributable to sources within this state":

"Income derived from or attributable to sources within this state" includes income from tangible or intangible property located or having a situs in this state and income from any

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activities carried on in this state, regardless of whether carried on in intrastate, interstate or foreign commerce.

A.R.S. § 43-1096(A) provides a credit for nonresidents shall be allowed a credit against taxes imposed by this title for net income taxes imposed by and paid to the state or country of residence on income taxable under this title.

Arizona Administrative Code "A.A.C." R15-2C-601(D)(4)(g)(iii) provides non-resident attorneys, physicians, accountants, engineers, etc., even though not regularly engaged in carrying on their professions in this state, must include in gross income as income from sources within this state the entire amount of fees or compensation for services performed in this state on behalf of their clients.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in the Request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this private taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.