

September 30, 2006 that included as business income the interest, dividends and miscellaneous income that had been excluded by Taxpayer.

8. The assessment included interest at the statutory rate and late filing penalties.
9. Taxpayer timely protested the assessment stating that:
 - a. the interest, dividend and miscellaneous income should not be added back to the Arizona computation because those funds were not used in the function of running the [REDACTED] of the company;
 - b. the other items being disallowed were not discussed with the Taxpayer before the assessment was issued; and
 - c. the assessment was issued several years after the audit was conducted and interest should be adjusted for the delay.
10. Taxpayer testified at the hearing that:
 - a. The miscellaneous income received by Taxpayer were reimbursement payments from a co-tenant in the same building occupied by Taxpayer for shared expenses such as utilities, insurance, property taxes, shared employees and office equipment leases.
 - b. The reimbursement was a way for Taxpayer to save some costs.
 - c. Taxpayer occupied approximately a half of the premises and the co-tenant the other half.
 - d. Taxpayer deducted the full amount of the shared expenses as business expenses.
 - e. Taxpayer did not reduce the total amount deducted by the reimbursement received from the co-tenant.
 - f. The dividends and interest were received from an investment account with [REDACTED].
 - g. Taxpayer did not use the dividends, interest or investments in the [REDACTED] account for its working capital or bonding capacity.

- h. Taxpayer did occasionally make available funding from the account to the co-tenant so the co-tenant could make payroll. The funds would be promptly repaid by the co-tenant and deposited into the account.
 - i. Taxpayer established the investment account to have funds available to purchase or redeem the outstanding shares of Taxpayer's deceased or retiring shareholders.
 - j. Taxpayer reported and paid tax to California on 100% of the [REDACTED] investment income at issue here.
11. The Section testified at the hearing that:
- a. The [REDACTED] account activity summary showed transfers in and out of the account that indicated short term use of the funds.
 - b. The transfers had the appearance of the funds in the [REDACTED] account being used for working capital of the business.
12. Taxpayer has presented no evidence showing that its failures to timely file the returns were due to reasonable cause and not due to wilful neglect.

CONCLUSIONS OF LAW

- 1. Any corporate taxpayer having income from business activity which is taxable both within and without Arizona is required to allocate and apportion its net income as provided in Title 43, Ch. 11, Art. 4. Arizona Revised Statutes (A.R.S.) § 43-1132(A).
- 2. A taxpayer's business income is apportioned to the states where the taxpayer operates. Title 43, Ch. 11, Art. 4.
- 3. A taxpayer's nonbusiness income is allocated to the state of the taxpayer's commercial domicile. Title 43, Ch. 11, Art. 4.
- 4. A taxpayer's commercial domicile is the principal place from which the trade or business of the taxpayer is directed or managed. A.R.S. § 43-1131(2)
- 5. Taxpayer's commercial domicile was in the state of California.

6. Business income is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. A.R.S. § 43-1131(1).
7. Nonbusiness income is all income that is not business income. A.R.S. § 43-1131(4).
8. For purposes of administration, the income of a taxpayer is business income unless clearly classifiable as nonbusiness income. Arizona Administrative Code (A.A.C.) R15-2D-501(A).
9. All transactions and activities of a taxpayer that are the result of or incidental to the operations of a particular trade or business of the taxpayer are transactions and activity arising in the regular course of, and constitute integral parts of, a trade or business. A.A.C. R15-2D-501(B).
10. Taxpayer did not use the [REDACTED] account in the regular course of its trade or business.
11. The [REDACTED] account did not constitute an integral part of Taxpayer's regular trade or business operations.
12. The dividend and interest income Taxpayer received from the [REDACTED] account was nonbusiness income.
13. Taxpayer received reimbursements for the co-tenant's use of property, facilities and personnel Taxpayer used in its regular trade or business.
14. The reimbursements were incidental to the operation of Taxpayer's trade or business.
15. The reimbursements Taxpayer received were business income.
16. The Section's proposed assessment dated March 23, 2009 for tax years ending September 30, 1995 through September 30, 2006 is upheld in part. The Section

shall remove from the proposed assessment the dividend and interest income Taxpayer received from the [REDACTED] account.

17. A.R.S. § 42-1123(C) provides that if the tax “or any portion of the tax is not paid” when due “the department shall collect, as a part of the tax, interest on the unpaid amount” until the tax has been paid.
18. A fiscal year taxpayer is required to file its Arizona income tax return on or before the fifteenth day of the fourth month following the close of the fiscal year. A.R.S. § 43-325.
19. Taxpayer’s fiscal year ended September 30, and its income tax returns were required to be filed on or before January 15 of the subsequent year.
20. Taxpayer did not timely file its income tax returns during the audit period.
21. A.R.S. § 42-1125(A) imposes a penalty for failure to file an Arizona income tax return when due.
22. The failure to file when due penalty may be abated only if the failure to file “is due to reasonable cause and not due to wilful neglect.” A.R.S. § 42-1125(A).
23. Taxpayer has presented no evidence to show that its failure to file when due was due to reasonable cause and not due to wilful neglect.
24. Interest and the late filing penalty were properly included in the proposed assessment. A.R.S. §§ 42-1123(C) and 42-1125(A).
25. The Director may, in his discretion, abate all or part of any assessment if additional interest has accrued on a deficiency due to any unreasonable error or delay by an officer or employee of the department. A.R.S. § 42-2065.
26. The Director’s decision under A.R.S. § 42-2065 is the Department’s final decision and is subject to appeal to the Arizona State Board of Tax Appeals. A.R.S. § 42-2065(C).
27. The Hearing Office lacks jurisdiction to address whether or not interest may be abated under A.R.S. § 42-2065.

DISCUSSION

Taxpayer filed its Arizona corporate income tax returns excluding certain income it considered nonbusiness income. The Section issued a proposed assessment to Taxpayer including the income in Taxpayer's apportionable income as business income. Taxpayer protested contending that the income did not arise from Taxpayer's business operations and was therefore nonbusiness income. Taxpayer also requested that a portion of the interest included in the proposed assessment be abated due to unreasonable delay by the Department.

[REDACTED] Interest and Dividends.

Taxpayer had placed funds into a [REDACTED] account. The account produced dividend and interest income during the audit period. The question is whether that income constituted business or nonbusiness income.

Business income is defined as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. The Department's administrative rules further provide that transactions and activities of a taxpayer that are the result of or incidental to the operations of a particular trade or business of the taxpayer are transactions and activity arising in the regular course of, and constitute integral parts of, a trade or business.

The Section had presumed that Taxpayer was using the investment account for working capital because of periodic transfers out and corresponding transfers in to the account. Taxpayer testified under oath that the transfers were short term loans to another company so that company could meet its payroll. Taxpayer testified it was not using the account in its own business for working capital or other purposes, such as bonding capacity.

Based on the evidence presented, Taxpayer did not use the [REDACTED] account in the regular course of its business. The dividend and interest income from the [REDACTED] account was therefore nonbusiness income and should be removed from the proposed assessment.

Miscellaneous Income.

The miscellaneous income arose from reimbursements Taxpayer received from its co-tenant for certain shared expenses. The expenses were generated by property, personnel and utilities Taxpayer used in its regular trade or business. The reimbursements included costs for items such as utilities, insurance, property taxes, shared employees and office equipment leases. Taxpayer deducted the full amount of the expenses as ordinary and necessary business expenses. The reimbursement was a way for Taxpayer to save some costs.

Because the reimbursements arose from allowing Taxpayer's co-tenant to use resources Taxpayer used in its trade or business, the reimbursements constituted income from property the acquisition, management and disposition of which constituted integral parts of Taxpayer's regular trade or business operations. The reimbursements were thus incidental to the operations of Taxpayer's trade or business. Taxpayer's miscellaneous income constituted business income and was properly included in the proposed assessment.

The proposed assessment included interest. A.R.S. § 42-1123(C) provides that if the tax "or any portion of the tax is not paid" when due "the department shall collect, as a part of the tax, interest on the unpaid amount" until the tax has been paid. For Arizona purposes, therefore, interest is a part of the tax and generally may not be abated unless the tax to which it relates is found not to be due for whatever reason.

The proposed assessment also included a penalty for failure to file when due. A.R.S. § 42-1125(A) provides in part:

A. If a taxpayer fails to make and file a return for a tax administered pursuant to this article on or before the due date of the return or the due date as extended by the department, then, unless it is shown that the failure is due to reasonable cause and not due to wilful neglect, four and one-half per cent of the tax required to be shown on such return shall be added to the tax for each month or fraction of a month elapsing between the due date of the return and the date on which it is filed. The total penalty shall not exceed twenty-five per cent of the tax found to be remaining due. . . .

Taxpayer failed to timely file its returns during the audit period. The failure to file when due penalty may be abated only if the failure to file "is due to reasonable cause and not due to wilful neglect." A.R.S. § 42-1125(A). "Reasonable cause" is generally defined to mean the exercise of "ordinary business care and prudence." *Daley v. United States*, 480 F. Supp. 808 (D.N.D. 1979). Taxpayer has not established reasonable cause. Therefore, the imposition of the failure to file when due penalty is upheld.

Interest Abatement.

Taxpayer requested the Hearing Officer to abate a portion of the interest included in the proposed assessment that accrued due to substantial delay by the Section in issuing the proposed assessment and scheduling the hearing. A.R.S. § 42-2065 allows the Director of the Department to abate interest where it is found that such additional interest was due to an "unreasonable error or delay" by a Department employee and no significant aspect of the error or delay can be attributed to the taxpayer. The authority to abate interest is given to the Department's Director and not the Hearing Office. The Director's decision may be appealed to the Arizona State Board of Tax Appeals. The Hearing Officer lacks jurisdiction to address whether or not interest may be abated in this matter.

Based on the foregoing, the Section's proposed assessment dated March 23, 2009 for tax years ending September 30, 1995 through September 30, 2006 is upheld in part. The Section properly included in the proposed assessment the reimbursements Taxpayer received from its co-tenant for shared expenses. The Section shall remove

from the proposed assessment the dividend and interest income Taxpayer received from the [REDACTED] account. To the extent the tax due under the assessment is reduced, related penalty and interest should also be reduced.

DATED this 30th day of July, 2012.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[REDACTED]
Hearing Officer

Original of the foregoing sent by
certified mail to:

[REDACTED]

Copies of the foregoing mailed to:

[REDACTED]

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Appeals Section