

# STATE OF ARIZONA

Department of Revenue  
Office of the Director  
(602) 716-6090



Janet Napolitano  
Governor

Gale Garriott  
Director

**CERTIFIED MAIL** [Redacted]

The Director's Review of the Decision  
of the Hearing Officer Regarding:

[Redacted]

**UTI No.** [Redacted]

**ORDER**

**Case No. 200500205-I**

On January 23, 2006 the Hearing Officer issued a decision regarding the protest of [Redacted] ("Taxpayers"). Taxpayers appealed this decision on February 23, 2006. As the appeal was timely, the Director of the Department of Revenue ("Director") issued a notice of intent to review the decision.

In accordance with the notice given the parties, the Director has reviewed the Hearing Officer's decision and now issues this order.

**Statement of Case**

The Individual Income Tax Audit Section of the Division ("Division") issued a deficiency assessment to Taxpayer for tax year [Redacted]. Taxpayers protested the assessment, and the Hearing Officer denied the protest. On appeal, Taxpayers argue that they should not be taxed on the gain from the Washington property they transferred in a like-kind exchange in 1994 because they weren't residents of Arizona at that time, that they paid Washington's transfer tax and that Arizona's statutes are obsolete and need to be updated. The Division argues that the deferred gain from that exchange was recognized upon the 2000 sale of the property which Taxpayers received in that exchange when Taxpayers were residents of Arizona and that since there is no deduction or credit applicable, Taxpayers must pay tax on the entire amount of the gain recognized in 2000.

### **Findings of Fact**

The Director adopts and incorporates into this order the findings of fact set forth in the decision of the Hearing Officer as follows:

1. Taxpayers were residents of Washington in 1994.
2. Taxpayers became residents of Arizona in 1998 and were residents of Arizona in 2000.
3. In 1978 Taxpayers purchased real property in Washington for \$[Redacted].
4. In 1994 Taxpayers entered into a like kind exchange of this Washington property for real property in Arizona.
5. Taxpayers elected to use I.R.C. § 1031 to defer the gain on the 1994 transfer.
6. On June 7, 2000, Taxpayers sold the Arizona property for \$[Redacted].
7. On their federal income tax return for 2000 Taxpayers showed a gain of \$[Redacted].
8. On their state income tax return for 2000 Taxpayers deducted \$[Redacted], which they claim represented the gain on the Washington property transferred in 1994.
9. The Section disallowed Taxpayers' subtraction of \$[Redacted] and issued a proposed assessment that included tax, a late payment penalty and interest.

### **Conclusions of Law**

1. Every resident of this state must pay a tax measured by taxable income wherever derived. A.R.S. § 43-102.A.4
2. Taxpayers were residents of Arizona during 2000; therefore, all of their income wherever derived was subject to Arizona tax, including the entire gain of \$[Redacted] on the Arizona property sold that year.
3. Taxpayers properly included the gain of \$[Redacted] in their federal adjusted gross income for 2000.
4. An individual taxpayer computes Arizona taxable income by starting with federal adjusted gross income. See A.R.S. § 43-1001.

5. Taxpayers properly used their federal adjusted gross income as the starting point in the calculation of the Arizona taxable income.
6. The right to a deduction or subtraction does not exist in the absence of statutory authority. *Arizona Department of Revenue v. Transamerica Title Insurance Company*, 124 Ariz. 417, 604 P.2d 1128 (1979).
7. There is no provision in the Arizona statutes that would allow a full-year Arizona resident to exclude deferred gains realized from the exchange of real property located in Washington for property located in Arizona.
8. Taxpayers had no authority to subtract \$[Redacted] on their 2000 Arizona resident income tax return.
9. A.R.S. § 43-1071 allows a credit for net income taxes paid to another state. Washington's transfer tax is not a net income tax. Washington Revised Code § 82.45.060.
10. Taxpayers are not entitled to a credit for taxes paid to Washington in 1994 for the transfer of the Washington property. A.R.S. § 43-1071.

### **Discussion**

In 1994 Taxpayers chose to enter into a like kind exchange, transferring their Washington property and acquiring a property in Arizona. Presumably they did this because they wanted the benefits of I.R.C. § 1031. One of the consequences of electing to use I.R.C. § 1031 is that the property acquired takes the basis of the property transferred. I.R.C. § 1031(d). When Taxpayers sold their Arizona property in 2000, they were able to deduct the basis of their property from the sales price in calculating the gain. This resulted in a gain of \$[Redacted], which Taxpayers reported on their federal income tax return.

An individual taxpayer computes Arizona taxable income by starting with federal adjusted gross income, makes certain additions and subtractions pursuant to A.R.S. §§ 43-1021 and 43-1022 and then is allowed certain exemptions and itemized deductions. See A.R.S. § 43-1001. Taxpayer's federal adjusted gross income included all \$[Redacted] of the gain

from the sale of the Arizona property. Taxpayers deducted \$[Redacted] on their 2000 Arizona resident income tax return, reasoning this amount represented the portion of the gain that was attributable to the property in Washington. The Division denied the subtraction.

A.R.S. § 43-102.A.4 states that "[i]t is the intent of the legislature...[t]o impose on each resident of this state a tax measured by taxable income wherever derived." Taxpayers were residents of Arizona during 2000; therefore, all of their income wherever derived was subject to Arizona tax, including the \$[Redacted] amount. Furthermore, A.R.S. § 43-102.A.1 provides that it is the intent of the legislature to adopt the provisions of the federal Internal Revenue Code relating to the measurement of adjusted gross income for individuals so that adjusted gross income reported to the IRS shall be the identical sum reported to Arizona, subject only to modifications set forth in Title 43 of the Arizona Revised Statutes. The \$[Redacted] was properly included in Taxpayers' federal adjusted gross income for 2000.

Taxpayers argue that Arizona may not tax \$[Redacted] of the gain because that portion of the gain was made while Taxpayers were residents of Washington, not Arizona. However, there is no provision in the Arizona statutes that would allow a full-year Arizona resident to exclude deferred gains realized from the exchange of real property located in Washington. The right to a deduction or subtraction does not exist in the absence of statutory authority. *Arizona Department of Revenue v. Transamerica Title Insurance Company*, supra. Taxpayers had no authority to subtract \$[Redacted] on their 2000 Arizona resident income tax return.

Taxpayers argue that there should be such a subtraction and that Arizona's law is outdated and obsolete because it does not address this situation. Decisions on what may be deducted, subtracted or excluded from income are made first by Arizona's legislature and then approved or vetoed by the governor. Administrative agencies, such as the Department of Revenue, have no common law or inherent powers. *Cf., Cox v. Pima County*

*Law Enforcement Merit System*, 27 Ariz. App. 494, 556 P.2d 342 ( 1976). Their powers and duties are measured by the statutes creating them. *Fleming v. Pima County*, 125 Ariz. 523, 611 P.2d 110 (App. 1980). As an administrative agency the Department of Revenue does not have the authority to allow a deduction not provided by statute even if, as Taxpayers argue, it is unreasonable not to have such a deduction.

Taxpayers also argue that A.R.S. § 43-102.A.4 uses the phrase “wherever derived” and not “whenever derived.” They state that the \$[Redacted] gain took place in 1994 when they were not Arizona residents. As stated above, one of the consequences of their choices in 1994 is that Taxpayers’ basis in the Arizona property was \$[Redacted] less than had they sold their Washington property for cash and had purchased the Arizona property. They would have been required to pay federal income tax on the \$[Redacted] gain in 1994. Washington did not have an income tax, and Taxpayers, who were not then Arizona residents, would have had no Arizona income tax liability.

....[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not.

*C.I.R. v. National Alfalfa Dehydrating & Milling Co.* 417 U.S. 134, 149 (1979) citing *Higgins v. Smith* 308 U.S. 473, 477 (1940). Taxpayers chose a different structure to their transactions and the tax consequences are different. The gain of \$[Redacted] was recognized due to a 2000 sale, therefore, it is appropriate for Arizona to tax the gain in [Redacted].

Taxpayers argue that they paid a state tax on \$[Redacted] of the gain in 1994 by way of a transfer tax to Washington. As the Division points out, Arizona provides some relief for taxpayers who pay income tax to another state as well as to Arizona. A.R.S. § 43-1071 allows a “credit against the taxes imposed by this chapter for net income taxes imposed by and paid to another state or country on income taxable under this chapter.” Unfortunately,

Taxpayers have not shown that the Washington real property transfer tax is a "net income tax." Also, the transfer tax was paid in 1994 not 2000.

Taxpayers state that refusing to allow a credit because a transfer tax is not a net income tax is splitting hairs. Taxpayers have not provided the statutory provision for the imposition of the transfer tax they paid. However, in 1994 Washington did tax the sale of real property pursuant to Washington Revised Code § 82.45.060. The tax is a percentage of the selling price. "Selling price" is determined by true and fair market value. Washington Revised Code § 82.45.030. Not only is the tax not on "net income", as required by A.R.S. § 43-1071, the tax is on a gross selling price or fair market value rather than on income. To qualify for the credit, the tax must be an income tax that allows deductions, exclusions or other income adjustments. *Arizona Department of Revenue v. Short*, 192 Ariz. 322, 325, 965 P.2d 56, 58 (App. 1998). No relief is available to Taxpayers under A.R.S. § 43-1071. There is no provision in the Arizona statutes that would allow a full-year Arizona resident to exclude deferred gains realized from the exchange of real property located in Washington. Taxpayers had no authority to subtract \$[Redacted] on their 2000 Arizona resident income tax return.

Pursuant to A.R.S. § 42-1125.D, the late payment penalty may be abated only if the failure to timely pay is due to reasonable cause and not due to wilful neglect. "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). Insufficient evidence has been provided to establish reasonable cause. Therefore, the imposition of the late payment penalty must be upheld.

As to the interest portion of the assessment, 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 tax was due in this case and the associated interest cannot be abated.

The Division's assessment was proper.

**ORDER**

The Hearing Officer's decision is affirmed.

This decision is the final order of the Department of Revenue. Taxpayer may contest the final order of the Department in one of two manners. Within 60 days of the receipt of the final order, Taxpayer may file an appeal to the State Board of Tax Appeals, 100 North 15<sup>th</sup> Avenue, Suite 140 Phoenix, AZ 85007 or, if the amount in dispute is greater than five thousand dollars, Taxpayer may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003). For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 24th day of July, 2006.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott  
Director

Certified original of the foregoing  
mailed to:

[Redacted]

GG:st

cc: Individual Income Tax Appeals Section  
Individual Income Tax Audit Section  
Audit Division