

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)
)
[REDACTED])
)
UTI #[REDACTED])
)
)
)
)
)

DECISION OF
ACTING HEARING OFFICER
Case No. 200900004-I

A telephone hearing was held on February 3, 2009, in the matter of the protest of [REDACTED] (Petitioners) of an assessment of income tax and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2002. The record in this matter was left open until April 21, 2009 to allow for post-hearing memoranda. Petitioners timely filed their opening post-hearing memorandum by postmark dated March 2, 2009. The Section timely filed its response memorandum on March 26, 2009. Petitioners' reply memorandum was due on April 21, 2009, but as of this date, the Hearing Office has not received a reply memorandum from Petitioners. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

In 2002, Petitioner [REDACTED] was a partner with an accounting firm ("the Partnership") that maintained offices in Arizona and in other states. The Partnership filed composite income tax returns on behalf of its non-resident partners in various states. Petitioners were Arizona residents in 2002 and participated in composite returns filed in other states. Petitioners filed a 2002 Arizona individual income tax return in which they claimed a credit in the amount of \$[REDACTED] for

income taxes paid to other states pursuant to Arizona Revised Statutes ("A.R.S.") § 43-1071. With their return, Petitioners submitted an affidavit ("Affidavit"), signed by the Partnership's Director of Partnership Taxes, concerning distributive shares of Partnership income reported and income taxes paid to other states by the Partnership on behalf of Petitioner [REDACTED]. The Affidavit also states local income taxes paid through the Partnership.

The Section audited Petitioners' 2002 Arizona return and reduced Petitioners' credit for income taxes paid to other states by \$[REDACTED] to an adjusted amount of \$[REDACTED]. On January 4, 2007, the Section issued a proposed assessment for additional tax of \$[REDACTED] plus \$[REDACTED] interest, at a total amount of \$[REDACTED]. No penalties were assessed.

Petitioners timely protested the proposed assessment and submitted a new calculation of the credit, claiming that the total credit for taxes paid to other states should be increased to \$[REDACTED] based on the decision in *Stearns v. Arizona Department of Revenue*, 212 Ariz. 333, 131 P.3d 1063, (App. 2006). The Section denied Petitioners' protest and refund request and recalculated the credit on the basis of its interpretation of the *Stearns* decision, arriving at a total revised credit amount of \$[REDACTED]. The Section, however, conceded a mathematical error in the assessment that affected the sum of the credit amounts for taxes paid to other states and not the computation of the individual credit amounts. The Section informed Petitioners by letter of December 16, 2008,

that the allowed credit amounts set forth in the assessment actually total \$[REDACTED] and stated its willingness to accept that credit amount and the resulting reduction of the assessment.

Petitioners subsequently requested a formal hearing, and a hearing was held on February 3, 2009. At the hearing, Petitioners acknowledged that they had erroneously included city taxes in their calculation of taxes paid to other states and that this affected the credit amounts they had computed for taxes paid to [REDACTED] and [REDACTED]. The erroneously included city taxes are \$[REDACTED] for [REDACTED] and \$[REDACTED] for [REDACTED]. Petitioners further acknowledged that they had made an error in listing the tax paid to [REDACTED] and that the correct amount of that tax should be \$[REDACTED] and not \$[REDACTED]. Petitioners conceded that the computation of the credit for taxes paid to [REDACTED], [REDACTED] and [REDACTED] should be modified accordingly.

Petitioners argue that the Section used an incorrect formula to calculate the credit for taxes paid to other states. Petitioners assert that the fraction, which is multiplied with a taxpayer's Arizona tax to arrive at the maximum allowable credit amount for each state pursuant to A.R.S. § 43-1071(A)(3), should include a numerator in the amount of the income that is taxable in the other state, as determined by that state. Petitioners argue that there is no basis in Arizona law for applying pro-rated Arizona deductions to the income from the other state for purposes of calculating the allowable credit amount.

Petitioners further argue that the Arizona Court of Appeals in *Stearns* did not change the calculation of the numerator in the credit fraction, but that it addressed only the determination of the denominator.

In their post-hearing memorandum, Petitioners assert that the Affidavit from the Partnership, which Petitioners submitted with their original Arizona tax return, states the amounts of taxable income for each state. In their original Arizona tax return, Petitioners used the amounts from that Affidavit as reportable income for purposes of the credit for taxes paid to other states. With their post-hearing memorandum, Petitioners submitted a new schedule that indicates "Income Before Deduction", "Income per Affidavit" and the difference between both amounts for each state. Petitioners state that they received that schedule, showing the income in the state before deductions and the deductions allowed, but that they were unable to get a copy of the composite returns filed by the Partnership.

The Section reiterated its concession of a mathematical error in the assessment and acknowledged that the auditor had added the states' credits incorrectly. Referring to its revised calculation of a credit amount of \$[REDACTED], the Section conceded that the assessment should be reduced to additional tax of \$[REDACTED] together with applicable interest.

The Section argues that pursuant to A.R.S. § 43-1071(A)(3), the numerator of the fraction used to calculate the credit is the income subject to tax in the other state or country and also taxable under A.R.S. Title 43 and that, accordingly, the income

reported to the other state must be adjusted to determine the portion of that income that is taxable under Arizona law. The Section asserts that the *Stearns* decision also requires consideration of the portion of the out-of-state income that is taxable under Arizona law. The Section further argues that the Arizona exemptions and deductions are not specifically related to only the Arizona income and must be applied on a pro-rata basis to determine what portion of the out-of-state income is taxable under Arizona law. If the out-of-state income is not reduced on such a pro-rata basis, the Section argues, the amount of the out-of-state income taxable in both Arizona and the other state could exceed the Arizona taxable income, which would be absurd because the numerator in the credit fraction should never exceed the denominator.

At issue is the calculation of the credit for taxes paid in other states and the propriety of the proposed assessment and refund denial.

CONCLUSIONS OF LAW

Petitioners are seeking a tax credit in an amount larger than the Section allowed in its assessment and in its revised calculation of the credit. An assessment of additional income tax is presumed correct. See *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 191 P.2d 729 (1948). Tax credits are obtained by legislative grace and not by right. *DaimlerChrysler Servs. N. Am., L.L.C. v. Ariz. Dep't of Revenue*, 210 Ariz. 297, 304, 110 P.3d 1031, 1038 (App. 2005). Tax statutes are

construed strictly against such credits. *Ariz. Dep't of Revenue v. Raby*, 204 Ariz. 509, 511, 65 P.3d 458, 460 (App. 2003).

The resolution of this matter turns on the interpretation of A.R.S. § 43-1071, which allows Arizona residents to claim a credit for net income taxes imposed by and paid to another state or country. A.R.S. § 43-1071(A)(3), as phrased prior to a 2008 amendment, imposes the following limitation on the credit:

The credit shall not exceed the proportion of the tax payable under this chapter as the income subject to tax in the other state or country and also taxable under this title bears to the taxpayer's entire income upon which the tax is imposed by this chapter.

A.R.S. § 43-1071(A)(3)¹. Under this limitation, the ratio between the maximum credit amount and "the tax payable under this chapter" is the same as the ratio between "the income subject to tax in the other state or country and also taxable under this title" and "the taxpayer's entire income on which the tax is imposed by this chapter." Expressed as a formula, A.R.S. § 43-1071(A)(3) limits the credit as follows:

$$\text{Maximum Credit} = \frac{\text{Income Subject to Tax in Other State/Country \& Taxable under Title 43}}{\text{Entire Income on Which Arizona Tax Is Imposed}} \times \text{Arizona Tax Liability Before Credit}$$

¹ For taxable years beginning from and after December 31, 2007, A.R.S. § 43-1071(A)(3) was amended by Laws 2008, Ch 220 to provide: "The credit shall not exceed the proportion of the tax payable under this chapter as the income subject to tax in the other state or country and also taxable under this title bears to the taxpayer's entire income on which the tax is imposed by this chapter." (Emphasis added.)

The parties disagree over the computation of the numerator in the formula's fraction. Petitioners argue that the numerator should be based upon the taxable income as determined by the other state, without applying pro-rata Arizona deductions. The Section takes the position that Arizona exemptions and deductions must be applied on a pro-rata basis to the out-of-state income, and that only an amount that is the smaller of that result or the taxable income as determined by the other state forms the numerator. At issue is therefore the meaning of the phrase that forms the numerator in the formula's fraction, "the income subject to tax in the other state or country and also taxable under this title." That phrase contains the twofold requirement, that the income that forms the numerator must be subject to tax in the other state or country, and that the income must be taxable under A.R.S. Title 43. A.R.S. § 43-1001(11) specifically defines "taxable income" of Arizona residents to mean Arizona adjusted gross income less the exemptions and deductions allowed in A.R.S. § 43-1041 et seq. Statutory interpretation must give effect to each word, phrase, and clause of the statute. *Ariz. Dep't of Revenue v. Superior Court (ASARCO Inc.)*, 189 Ariz. 49, 52, 938 P.2d 98, 101 (App. 1997). The inclusion of the term "taxable" in the phrase describing the numerator of the credit fraction in A.R.S. § 43-1071(A)(3) cannot be ignored. Reading the term "taxable under this title" in A.R.S. § 43-1071(A)(3) consistent with the definition of "taxable income" in A.R.S. § 43-1001(11) supports

the reduction of the out-of-state income by Arizona exemptions and deductions to determine the credit fraction's numerator.

Both parties cite the Arizona Court of Appeals' decision in *Stearns*. There, the issue was the computation of the credit fraction's denominator. The Court in *Stearns* stated:

Our determination that a resident taxpayer's "taxable income" forms the denominator of the tax credit fraction is also supported by the structure of § 43-1071(A), which is designed to provide residents "a credit against the taxes imposed by this chapter for net income taxes imposed by and paid another state or country on income taxable under this chapter" (Emphasis added.) Thus, the numerator of the fraction, which consists of "income subject to tax" in both the other state and Arizona, is equivalent to that portion of the out-of-state income that is taxable in both states, resulting in an "apple-to-apple" comparison, thereby preventing either a disproportionately high or low credit.

Stearns, 212 Ariz. at 335, 336, 131 P.3d at 1065, 1066. The Court clearly assumed that the portion of the out-of-state income that is taxable income in the other state and also taxable income in Arizona forms the numerator of the fraction. Based on that assumption, the Court concluded that the denominator also had to be taxable income instead of adjusted gross income to ensure an "apple-to-apple" comparison. The *Stearns* decision therefore further supports applying Arizona exemptions and deductions to the out-of-state income for purposes of calculating the credit fraction's numerator.

The credit limitation in A.R.S. § 43-1071(A)(3) ensures that the credit for taxes paid to another state or country is not larger than the Arizona tax that relates to the income from the other state or country. Without that limitation, a taxpayer could benefit from the credit beyond the proportion of his or her out-of-state income, resulting in tax credits larger than the Arizona tax imposed on that income. The credit limitation in A.R.S. § 43-1071(A)(3) therefore asks how much of a taxpayer's entire income taxable in Arizona is also subject to tax in the other state. That proportion indicates how much of the Arizona tax relates to the out-of-state income. The credit cannot exceed that amount of Arizona tax. Only when both the numerator and the denominator of the credit fraction include comparable income - the "apple-to-apple" comparison as referenced by the *Stearns* Court - does the result of the credit formula reflect the amount of Arizona tax that relates to the out-of-state income. The numerator must therefore include a pro-rata application of Arizona exemptions and deductions to the income from the other state or country. Only the amount that is the smaller of the taxable income as determined by the other state, or the Arizona taxable income from that state, forms the credit fraction's numerator.

Petitioners assert in their post-hearing memorandum that the new schedule, attached to that memorandum, states their income before deductions for each state, whereas the previously submitted Affidavit, signed by the Partnership's Director of Partnership Taxes, reflects only the taxable income after any

available deductions and the taxes paid to other states. This assertion contradicts Petitioners' use of the amounts per the Affidavit as the reportable income on the credit forms, Arizona Form 309, in Petitioners' original Arizona tax return as well as in the calculation they submitted with their protest and refund request. The new schedule is not an affidavit. It does not indicate its origin and is not signed. Arizona law requires taxpayers to keep and preserve "suitable records and other books and accounts necessary to determine the tax for which the person is liable for the period prescribed in § 42-1104." See A.R.S. § 42-1105.D. Petitioners have not provided the composite returns that the Partnership filed in the other states. The new schedule that Petitioners submitted with their post-hearing memorandum is insufficient evidence to demonstrate that the amounts of income used in the Section's revised credit calculation should be adjusted or that the Section improperly reduced Petitioners' credit. The Section's assessment must be upheld in the amount of the Section's revised credit calculation.

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.

Insofar as the tax was due in this case, the associated interest cannot be abated.

Based on the foregoing, the Section's January 4, 2007 assessment is affirmed, except that the Section shall make the modifications as proposed in its revised credit calculation of a credit amount of \$[REDACTED]. Petitioners' refund request is denied.

DATED this 16th day of June, 2009.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[REDACTED]
Acting Hearing Officer

Original of the foregoing sent by
certified mail to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Individual Income Tax Audit Section