

STATE OF ARIZONA

Department of Revenue
Office of the Director
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Janice K. Brewer
Governor

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Director

CERTIFIED MAIL [redacted]

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

[redacted]

UTI # [redacted]

) **ORDER**

) **Case No. 200800180- I**

On February 4, 2009 the Hearing Officer issued a decision regarding the protest of [redacted] ("Taxpayers"). Taxpayers appealed this decision on February 28, 2009. Because 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 Section of the Audit Division ("Division") determined that Taxpayers incorrectly subtracted \$5,341 for federal retirement contributions on Taxpayers' 2003 Arizona return. The Division requested information and Taxpayers failed to provide any documentation of the \$7,175 in medical expense deductions claimed on Taxpayers' 2003 return. A proposed assessment was issued showing additional tax and interest due , but no penalties. Taxpayers protested and later provided documentation of medical expenses resulting in the issuance of a modified proposed assessment allowing \$4,338.78 in medical expenses and reducing the assessment. Taxpayers agreed that they were not entitled to a deduction for federal retirement income but should not owe interest and also argued that they should be entitled to additional medical expense deduction. After a hearing the Hearing Officer upheld the modified proposed assessment.

On appeal Taxpayers also claim they are entitled to a medical expense deduction for insurance premiums paid through an employer, the federal government, and should not

be required to pay interest on the tax due for the federal retirement contributions they deducted.

Findings of Fact

The Director adopts from the Hearing Officer's findings of fact and makes additional findings as follows:

1. Taxpayers timely filed a 2003 Arizona individual income tax return claiming a \$5,341 subtraction from income for federal retirement contributions and a medical expense deduction of \$7,175.
2. In November 2004, Taxpayers were issued a notice of proposed assessment regarding their 2000 Arizona income tax. The sole adjustment made was the disallowance for the federal retirement contribution subtraction.
3. On November 15, 2007 the Division issued a proposed assessment on Taxpayers' 2003 income tax return, disallowing the \$5,341 subtraction for federal retirement contributions and all of the \$7,175 of medical expense deductions Taxpayers claimed on their return. The assessment showed tax due of \$468.38 and interest of \$123.38 through November 30, 2007.
4. Taxpayers have agreed that they are not entitled to the subtraction on their 2003 Arizona return for retirement contributions, but argue they should not pay interest on the \$5,341 of tax due starting on October 5, 2007.
5. Of the \$7,175 deducted as medical expenses \$4,338.78 was allowed in the modified proposed assessment leaving \$2,836.22 in dispute. During the hearing and the appeal process the only additional expense Taxpayers have argued should be allowed is a deduction for premiums for health insurance paid through Mr. [redacted]'s federal employer.
6. According to the Defense Finance and Accounting Office in Cleveland, Ohio during 2003, medical insurance premiums were paid out of wages that were not taxed.
7. The amount paid for medical insurance premiums for Mr. [redacted] was paid out of pre-tax dollars, was not reflected in the amount of taxable wages in box one of his W-2 form for 2003 and was not included in the amount shown as social security wages.

8. Taxpayers have not provided any information to show that the insurance premiums claimed were different than the medical insurance premiums paid through Mr. [redacted]'s federal employer.
9. Taxpayers received a letter dated October 5, 2007 from the Division in which they were notified of the audit for their 2003 income tax return.
10. Taxpayers' responded to the October 5, 2007 inquiry in a letter dated December 13, 2007 with their protest of the proposed assessment. Among other statements, Taxpayers stated, "Otherwise, please re-compute my tax owed to reflect the tax for the Federal Retirement Contributions portion of this audit only!" Nothing more was said about the contributions or interest on the assessment in this letter. The accompanying protest form showed that Taxpayers disagreed with the entire assessment.
11. In a letter dated January 16, 2008, Taxpayers stated "I have already stated I would pay the Federal Retirement Contribution portion of this audit. This is the last time I am going to make that offer. Let me know what I owe for that portion of the audit and forget that medical part."
12. In a letter dated March 17, 2008 the Division provided Taxpayers with a statement that the total tax and interest related to the federal retirement contribution issue was \$258.84.
13. Taxpayers claim they did not receive this letter; the Division states the letter was not returned by the post office.
14. In a letter dated April 16, 2008, the Division stated to the Taxpayers that the portion of the assessment, tax and interest, attributable to the federal retirement contribution issue was \$259.96.
15. In a letter dated May 8, 2008 Taxpayers stated, "Lastly, **I WILL NOT** pay any interest or penalty on the amount of monies attributable to the Federal Retirement Contributions... If you tell me what that amount was at the beginning, I may pay that amount – but I will not pay any interest or penalties."

16. In a letter dated May 21, 2008 Taxpayers provided information related in medical expenses, complained about the auditor, but did not renew the request for the tax only portion of the assessment related to federal retirement contributions.
17. A notice of modified proposed assessment was issued on July 2, 2008. The notice showed that \$4,338.78 was being allowed for medical expenses and that the total tax was \$306.11 and interest through July 17, 2008 was \$96.51.
18. In a letter dated August 8, 2008, the Division asked the Taxpayers to respond to the modification and explained that the instructions for line 15 of the 2003 return (where the federal retirement contributions could be taken) stated that if the contributions were subtracted and courts found for the Department, then the taxpayer would be responsible for additional tax and accrued interest. Further the Division stated that the tax and interest attributable to the federal retirement contributions was \$264.69.
19. With a letter dated August 24, 2008 Taxpayers sent a check for \$61.44 claiming they were entitled to subtract \$77.50 for cost of providing documentation of medical expenses.
20. Taxpayers have not made additional payments on their 2003 tax liability.
21. In its Response Memorandum dated April 10, 2009, the Division stated that the additional tax on the federal retirement contribution adjustment is \$200.03.

Conclusions of Law

The Director adopts conclusions of law from the Hearing Officer's Decision and makes additional conclusions as follows:

1. "The presumption is that an additional assessment of income tax is correct and the burden is on the taxpayer to overcome such presumption." *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 105, 191 P.2d 729 (1948).
2. The burden is on the Taxpayers to show they are entitled to a deduction or exemption from tax. See *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969).

3. Arizona law requires that taxpayers *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.” A.R.S. § 42-1105(D).
4. A.R.S. § 43-1042(A) provides:

Except as provided by subsections B, D and E of this section, at the election of the taxpayer, and in lieu of the standard deduction allowed by § 43-1041, in computing taxable income the taxpayer may take the amount of itemized deductions allowable for the taxable year pursuant to subtitle A, chapter 1, subchapter B, parts VI and VII
5. Taxpayers elected to itemize deductions pursuant to A.R.S. § 43-1042(A).
6. Subtitle A, chapter 1, subchapter B, parts VI and VII, of the internal revenue code includes a deduction for “expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent ... to the extent such expenses exceed 7.5 percent of adjusted gross income.” I.R.C. § 213 (a).
7. A.R.S. § 43-1042(B) provides that in lieu of deducting the amount of medical care expenses provided in I.R.C. § 213, taxpayers may deduct the full amount of such expenses.
8. Taxpayers failed to meet their burden of proving the amount of medical insurance premiums paid.
9. Taxpayers failed to meet their burden of proving that the insurance premiums claimed were different than the medical insurance premiums paid through Mr. [redacted]’s employer.
10. Employer paid accident and health insurance premiums are generally excludible from the employee’s gross income. I.R.C. § 106.
11. Premiums paid with pre-tax dollars are already deducted from a taxpayer’s gross income to calculate their taxable income and taxpayers may not deduct their premiums again as an itemized medical expense. See, A.R.S. § 43-102(B).

12. An employer may elect to provide medical insurance for its employees and use a “cafeteria plan” which allows the employee to exclude the cost of premiums paid for by that plan from the employee’s gross income. See, I.R.C § 125. Without such a plan, the cost of the premiums paid would be included in the employee’s gross income. I.R.C § 61.
13. A premium-only-plan is a cafeteria plan that offers as its sole benefit an election between cash (for example, salary) and payment of the employee share of the employer-provided accident and health insurance premium (excludible from the employee's gross income under I.R.C. § 106).
14. The medical insurance premiums paid through Mr. [redacted]’s employer were excluded from his gross income under I. R.C. §§ 106 and 125.
15. Taxpayers have not met their burden of proof of entitlement to the claimed medical deduction for insurance premiums.
16. There is no provision in Arizona law for a subtraction for tax liability for the cost of providing documentation to prove entitlement to deductions.
17. Taxpayers are entitled to the credit of \$61.44 for the check they sent, but not to a subtraction for the \$77.50 of costs.
18. 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.
19. The interest was properly assessed.
20. The Hearing Officer correctly denied Taxpayers’ protest of the modified proposed assessment.
21. A.R.S. § 42-2065 provides that the Director of the Department may abate interest where it is found that such additional interest was due to an “unreasonable error or delay” by a Department employee, but “only if no significant aspect of the error or delay can be attributed to the taxpayer.”
22. There was no unreasonable error or delay by a Department employee. Further, the Division’s delay in telling the Taxpayers the amount of tax attributable to the

federal retirement contribution was caused in significant part by the lack of clarity in Taxpayers' communications.

23. No interest should be abated under A.R.S. § 42-2065.

Discussion

On their timely filed 2003 Arizona individual income tax return Taxpayers claimed a \$5,341 subtraction from income for federal retirement contributions and medical expense deductions of \$7,175. On or about October 5, 2007, the Division sent Taxpayers a letter informing them that their 2003 Arizona income tax return had been selected for audit, requesting that Taxpayers provide information regarding their medical expenses and stating that failure to furnish the requested information within 30 days would result in an assessment being issued based upon available information.

The Division issued a proposed assessment on November 15, 2007, disallowing the \$5,341 subtraction for federal retirement contributions and all of the \$7,175 of medical expense deductions Taxpayers claimed. The assessment showed tax due of \$468.38 and interest of \$123.38 through November 30, 2007. No penalties were assessed. Taxpayers timely filed protest of the proposed assessment along with a letter dated December 13, 2007.

On appeal, the two major issues relate to whether interest should be abated on part of the assessment and whether Taxpayers are entitled to a deduction for medical insurance premiums paid by an employer.

Taxpayers claim to have responded to the Division's October 5, 2007 letter and, in their Notice of Appeal of Decision of the Hearing Officer stated, "In that reply I asked what my amount owed was at that time." The Division states it did not receive the reply. However, from the record it appears that their reply was their December 13, 2007 letter.

In their December 13, 2007 letter Taxpayers stated that they lived in [redacted] and that they would not travel to Arizona to appear for an audit, but if they did, they would expect the State of Arizona to pay for their mileage and per diem costs. Further, Taxpayers stated they would not mail the original documentation to prove their medical

expenses and that copying and mailing the documents to the Department would be cost prohibitive. Finally, Taxpayers stated "..., please re-compute my tax owed to reflect the tax for the Federal Retirement Contributions portion of this audit only!" Nothing more was said about the contributions or interest on the assessment in this letter. The accompanying protest form showed that Taxpayers disagreed with the entire assessment.

The Division responded in a letter dated December 28, 2007 that Taxpayers' medical deductions would not be allowed without supporting documentation. Taxpayers replied via letter dated January 16, 2008 complaining that the Division's letter was not sent out on the date stated¹ and that the Division did not answer their questions about reimbursement for costs of travel or expenses to copy and mail documents to the Department. Taxpayers also stated that for documentation of medical expenses they would not send individual receipts but would be willing to provide a list of the doctors (or other provider) along with the amounts paid to such entity. Further Taxpayers stated "I have already stated I would pay the Federal Retirement Contribution portion of this audit. This is the last time I am going to make that offer. Let me know what I owe for that portion of the audit and forget that medical part."

The Division sent a letter to Taxpayers on March 17, 2008 in which the Division stated no adjustment could be made without documentation to support medical expenses. Further the letter stated that Taxpayers were not expected to travel to Arizona for a hearing and that a hearing may be held telephonically or by written memoranda. Finally, the letter stated that the total tax and interest related to the federal retirement contribution issue was \$258.84. Taxpayers claim they did not receive this letter; the Division states the letter was not returned by the post office. In a letter dated April 16, 2008, the Division stated to the Taxpayers that the portion of the assessment, tax and interest, attributable to the federal retirement contribution issue was \$259.96.

In a letter dated May 8, 2008 Taxpayers explained they were working on copying the documentation for medical expenses and the medical problems they were experiencing which was being adversely affected by having to copy documents. Further the letter

stated, “Lastly, **I WILL NOT** pay any interest or penalty on the amount of monies attributable to the Federal Retirement Contributions... If you tell me what that amount was at the beginning, I may pay that amount – but I will not pay any interest or penalties.”

In a letter dated May 21, 2008 Taxpayers provided documents and information related in medical expenses. Taxpayers stated, “If you need to know the exact amount I paid for health insurance premiums in 2003, get in touch with Blue Cross/Blue Shield of Arizona. I have had no luck getting this figure.” In the letter Taxpayers complained about the auditor and urged that he be fired. Taxpayers did not renew the request for the tax only portion of the assessment related to federal retirement contributions.

In its Response Memorandum on appeal, the Division described the documentation Taxpayers sent. While Taxpayers were afforded the opportunity to reply to the Division’s memorandum, they did not do so. The description, being undisputed is accepted as true. The box of receipts sent contained receipts showing \$2,745.58 in payments to doctors and hospitals and \$1,406.56 in prescription costs. In addition, in the letter Taxpayers gave information on mileage to different medical providers which, at 12 cents a mile, amounted to \$214.44. This added to a total of \$4,338.78.

On July 2, 2008, the Division issued a modified assessment allowing \$4,338.78 of the \$7,175 medical expense deductions claimed by Taxpayers on their 2003 return.

According to testimony provided at the hearing, the amounts disallowed as medical expense deductions related to Taxpayers’ medical premiums. The modified assessment also continued disallowing the deduction for federal retirement contributions. The tax due as recalculated on the modified assessment to \$306.11 and corresponding interest was reduced to \$96.51 (accrued through July 16, 2008).

In a letter dated August 8, 2008, the Division asked for the Taxpayer’s response to the modification and explaining that the instructions for line 15 of the 2003 return (where the federal retirement contributions could be taken) stated that if the contributions were subtracted and courts found for the Department, then the taxpayer would be responsible for

¹ Although the Division’s letter was dated December 28, 2007, the letter was not postmarked until January 8, 2008.

additional tax and accrued interest. Further the Division stated that the tax and interest attributable to the federal retirement contributions was \$264.69.

Taxpayers responded via letter dated August 24, 2008 stating that they did not receive the modified assessment. Taxpayers made these statements:

Now about the federal retirement thing I told you in my letter of 08 May 08 that I was not paying any interest or penalty on any portion of this cluge [sic] from when this mess started and that is what I meant. Perhaps I didn't make myself clear enough. All this . . . started 05 Oct 07 (that was the date of the letter from Mr. [redacted] advising us of this audit.) and I asked . . . in my reply to him then, and every other reply I sent to his letters what the federal retirement amount would have been on or about THAT date. I never got an answer and I am not paying any interest or penalties for any time after that date! Now, this mess has dragged on for over 10 more months on which you say I owe interest and penalties. WRONG. Again, tell me what that figure was on 10/05/08 and I will consider paying it, but not one red cent for anything past that date.

Also, with this letter Taxpayers sent a check for \$61.44. The letter explained this represented the amount the Division claimed they owed (\$403.63) less the amount attributable to the federal retirement contributions (\$264.69) less a \$.25 per page copy fee for 250 pages less \$15.00 for a box and the postage to send those copies. The Division subsequently sent Taxpayers another copy of the modified proposed assessment.

In its Response Memorandum on appeal, the Division stated that Mr. [redacted] was a federal employee. Further, the Division claimed that the Defense Finance and Accounting Office in Cleveland, Ohio confirmed that in 2003 medical insurance premiums were paid out of pre-tax wage dollars. Taxpayers did not dispute these statements, therefore, they are taken as true.

At the January 22, 2009 telephonic hearing, Mr. [redacted] reiterated the arguments set forth in the letters previously sent to the Division. He stated that he was unsure why the medical insurance premiums were disallowed in the Division's modified assessment. He also acknowledged that he owed the tax associated with the Federal Retirement Contributions and stated that his main objection was with regard to the interest assessed after October 5, 2007 (when he was initially contacted about the audit).

On appeal Taxpayers ask that interest on the tax associated with the Federal Retirement Contributions be abated after October 5, 2008 pursuant to A.R.S. § 42-2065 and that they be allowed a deduction for health insurance premiums as medical expenses.

Insurance Premiums

With regard to itemized deductions, A.R.S. § 43-1042(A) allows a taxpayer to take itemized deductions (as provided in the Internal Revenue Code) in lieu of a standard deduction. Subtitle A, chapter 1, subchapter B, parts VI and VII, of the internal revenue code includes a deduction for “expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent ... to the extent such expenses exceed 7.5 percent of adjusted gross income.” I.R.C. § 213 (a). A.R.S. § 43-1042(B) allows taxpayers to deduct the full amount of medical expenses in lieu of the amount allowed under I.R.C. § 213.

In the modified proposed assessment Taxpayers were allowed the full amount of the medical expenses for which they provided documentation. As stated above, they have not been able to get documentation from Blue Cross/Blue Shield of Arizona as to what was paid for premiums. Arizona law requires that taxpayers *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.” A.R.S. § 42-1105(D). “The presumption is that an additional assessment of income tax is correct and the burden is on the taxpayer to overcome such presumption.” *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 105, 191 P.2d 729 (1948). The burden is on the Taxpayers to show they are entitled to a deduction or exemption from tax. See *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969). Taxpayers failed to meet their burden of proving the amount of premiums paid.

Even if Taxpayers were able to document the amount of medical insurance premiums paid, Taxpayers would not be entitled to a deduction for the premiums. The Division points to the fact that the Defense Finance and Accounting Office confirmed that in 2003 insurance premiums were paid out of wages that were not taxed. Further, the

Division points out that medical insurance premiums does not show up on the W-2 forms as taxable wages in box one or even as social security wages. In Exhibit B attached to the Division's Response Memorandum on appeal, the Division provides a part of Publication 502 issued by the IRS. What is provided addresses the issue of what insurance premiums can be included in medical costs for purposes of the deduction of medical expenses. In part this Publication 502 states:

Do not include in your medical and dental expenses any insurance premiums paid by an employer-sponsored health insurance plan unless the premiums are included in box 1 of your Form W-2, Wages and Tax Statement. Also, do not include any other medical and dental expenses paid by the plan unless the amount paid is included in box 1 of your Form W-2.

Example:

You are a federal employee participating in the premium conversion plan of the Federal Employee Health Benefits (FEHB) program. Your share of the FEHB premium is paid by making a pre-tax reduction in your salary. Because you are an employee whose insurance premiums are paid with money that is never included in your gross income, you cannot deduct the premiums paid with that money.

Taxpayers argue that they have never heard of the distinction between pre and post tax payments regarding insurance premiums and that the local I.R.S. office and the "Accuracy Guarantee" of Turbo Tax also have not heard of any such thing. Taxpayers correctly state there is no mention of this pre and post distinction in either I. R. C. § 213(d)(1)(D) or A.R.S. § 43-1042. However, as demonstrated by the above quotation from Publication 502, there is a distinction. To understand why premiums paid out of "pre tax" dollars are not deductible it is necessary to look at the exclusions created in I.R.C §§106 and 125.

Employers may contribute accident and health insurance premiums to cover its employees and dependents. Generally all compensation to an employee is included in the employee's gross income. I.R.C § 61. However, I.R.C. § 106 provides an exclusion from

the employee's gross income for accident and health insurance premiums that the employer pays.

Sometimes an employer does not contribute all the insurance premiums, but requires employees to agree to pay for part of the premiums by a reduction in the wages the employee receives. This is called a "cafeteria plan". Under I.R.C § 125 medical insurance premiums amounts that are taken from the employee's wages are excluded from the employee's gross income. This is what is described in the related Treasury Regulations as "pre-tax" contribution.

According to the undisputed evidence from the Division, Taxpayer's employer provided a plan in 2003 where the insurance premiums were pre-tax. Additionally, the IRS Publication 502 addresses the Federal Employee Health Benefits (FEHB) program and explains that federal employees who receive their medical insurance coverage through this program cannot include the premiums in their medical expenses deduction. Taxpayers had the opportunity to refute the statements that Mr. [redacted]'s employer's insurance program were paid with pre-tax dollars and to refute that Mr. [redacted] was a part of the FEHB program. Taxpayers did not disagree with either of the assertions.

Taxpayers have not met their burden of proving that the medical insurance premiums paid through Mr. [redacted]'s employer was not excluded from his gross income under I. R.C. § 106 and, therefore, Taxpayers have not met their burden of proving that the premiums are deductible as medical expenses under I.R.C § 213. If the expenses are not deductible under I.R.C § 213, they are not deductible under A.R.S. § 43-1042.

Finally, the Hearing Officer correctly held that premiums paid with pre-tax dollars are already deducted from a taxpayer's gross income to calculate their taxable income and that taxpayers may not deduct their premiums again as an itemized medical expense. See, A.R.S. § 43-102(B).

Cost of Providing Documentation

Although not raised by Taxpayers on appeal, to avoid misunderstanding, the cost of the production of documentation of medical expenses must be addressed. With

Taxpayers' August 24, 2008 letter they sent a check for \$61.44, which represented the amount Division claimed they owed in the modified proposed assessment (\$403.63) less the amount attributable to the federal retirement contributions (\$264.69) and less an estimated cost of copying and mailing the documentation to support their claim for medical expenses (\$77.50).

As stated above. Arizona law requires that taxpayers *keep and preserve* suitable records and other books and accounts necessary to determine the tax. Also, the burden is on the Taxpayers to show they are entitled to a deduction or exemption from tax. Taxpayers chose to make copies of their documentation rather than risk mailing original receipts or than assume the cost of traveling from [redacted] to provide the documentation in person. To meet their burden of proving their entitlement for \$4,338.78 of the claimed medical expenses Taxpayer's paid \$77.50. There is no provision in law to allow taxpayers a subtraction from tax liability for cost of meeting their burden of proof of deductions. Taxpayers are entitled to the credit of the \$61.44 paid, but not to a subtraction for the \$77.50 of costs.

Interest Abatement on Federal Retirement Contribution Subtraction

Taxpayers now agree that the Division properly disallowed the federal retirement contribution subtraction taken by them on line 15 of their 2003 Arizona income tax return. Their complaint is about some of the interest that is being added to the tax due.

During 2003, the issue of the taxability of the federal retirement contribution was still being litigated in the courts. Accordingly, the Department's 2003 Instructions to Arizona Form 140 provided as follows:

Line 15 - Elective Subtraction of Federal Retirement Contributions

This line applies only to individuals who were civilian employees of the United States Government during 2003.

The Court of Appeals held that Arizona's taxing scheme for years after 1990 did discriminate against federal employees by

taxing their retirement plan contributions but not those of state and local employees. The department has appealed that determination to the Arizona Supreme Court, so the issue is not yet final.

Line 15 is provided to alert you to a remedy available to you under Arizona law. On your 2003 return, you have two options.

Option #1

You may subtract the amount of contributions made to your federal retirement plan during 2003. Enter on line 15 the 2003 amount of such contributions included in your federal adjusted gross income. If you choose this option and the courts ultimately decide that it is legal for the State of Arizona to tax your retirement contributions, you will owe additional tax and accrued interest. . . .

Option #2

You may choose to ignore line 15. You may instead file the protective claim form. This form is in this instruction booklet. Under this option you will pay tax on your contributions to the federal retirement plan. You will also protect your rights to a credit or refund of this tax if the courts ultimately decide that is appropriate. The state will pay interest in this event. The courts have been asked to award up to 20% of your refund to the attorneys in the case.

2003 Instructions to Arizona Form 140, p. 12 (emphasis added). Taxpayers chose “Option #1” and subtracted the amount of their federal retirement contribution on line 15 of their 2003 Arizona income tax return. By doing so, they were under notice by the Department’s forms that if “the courts ultimately decide that it is legal for the State of Arizona to tax [their] retirement contributions, [they] will owe additional tax and accrued interest.” (Emphasis added.)

In February of 2004, the Arizona Supreme Court issued an opinion holding that it was legal for Arizona to tax federal retirement contributions. See *Kerr v. Killian*, 207 Ariz. 181, 84 P.3d 446 (2004). The case was appealed to the United States Supreme Court, but the United States Supreme Court denied certiorari in October of 2004. See *Moran v. Hibbs*, 543 U.S. 810, 125 S.Ct. 39 (2004). Consistent with the 2003 Instructions to Arizona

Form 140, Taxpayers' 2003 Arizona return was subsequently audited and Taxpayers were assessed additional tax and accrued interest.

As to the interest portion of the modified 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 is therefore mandatory. Interest was properly assessed.

Taxpayers object to paying interest based on their assertion that the Division's auditor did not handle the audit appropriately. There are very few circumstances where interest may be abated under Arizona law. A.R.S. § 42-2065 provides that the Director of the Department may abate interest where it is found that such additional interest was due to an "unreasonable error or delay" by a Department employee, but "only if no significant aspect of the error or delay can be attributed to the taxpayer.

Taxpayers request that beginning October 5, 2007 the interest be abated on the tax associated with the incorrectly subtracted federal retirement contribution.

Regarding the period subsequent to October 5, 2007, Taxpayers in their Notice of Appeal state:

I admit that I owe for the deduction of federal retirement contributions. I have said that right from the beginning, in my reply to the notice of audit (5 Oct 2007). In that reply I asked what my amount owed was at that time. I never got an answer to that question! I repeated that question in every other letter/reply I sent to the department. This same question was asked in my letters dated: 13 December 2007, 16 January 2008, and 2 letters in May 2008 than my final letter August 24, 2008 requesting the hearing. AGAIN AND AGAIN, AND AGAIN and AGAIN I NEVER GOT THAT QUESTION ANSWERED!

Taxpayers are asserting the unreasonable delay was caused by employees of the department failing to provide them with the tax amount associated with the federal retirement contributions. The first letter in the record in which Taxpayers ask about the amount due is the December 13, 2007 letter. At that time they knew from the notice of proposed assessment that the tax on all issues was \$468.38 and all interest was \$123.38.

Until Taxpayers' January 16, 2008 letter, Taxpayers did not state they would pay the tax on the federal retirement contribution amount. Until the May 8, 2008 letter Taxpayers did not make it clear they would not pay the interest on that tax. The May 21, 2008 letter did not address the issue of the amount associated with the federal retirement contributions. With the August 24, 2008 letter Taxpayers said they would consider paying the tax and it appeared they might pay interest until October 5, 2008 .

The Division provided tax plus interest amounts on the federal retirement contribution amount on three occasions, March 17, 2008 (which Taxpayers state they didn't receive), April 16, 2008 and August 8, 2008. In a memorandum dated April 10, 2009, the Division stated the tax amount separate from the interest.

Taxpayers were alerted by the instructions of the tax return that they would owe interest if the court decision was unfavorable. Due to a notice of proposed assessment on the same issue for their 2000 tax year, Taxpayers knew in November 2004, the same year that they filed their 2003 tax return, that the court decision was unfavorable and they would also owe the tax and interest for 2003. Taxpayers said nothing about their 2003 tax liability until after being contacted by the Division in October 2007.

It would have been preferable had the auditor understood that Taxpayers were looking for a tax only number and provided it to them. While that did not happen, it was caused in part by the lack of clarity of the request. It was not clear that they wanted tax and not the interest associated with it and it was not clear what they intended to do with that information. In the August 24, 2008 letter where Taxpayers made it clear that they had intended to pay the tax, they stated they would now *consider* paying the tax if provided with that amount. Again, at that time it would have been preferable had the Division provided the Taxpayers with the tax amount and also an interest amount through October 5, 2007. However, given the lack of commitment to pay, it was not clear even at that point that the information would have resulted in payment.

The Division attempted to make Taxpayers aware of the tax plus interest amount due on the federal retirement contribution issue with its March 17, 2008 letter, which Taxpayers state they didn't receive. Taxpayers did receive the Division's April 16, 2008 and August 8, 2008 letters giving that combined amount. They also knew total tax and total

interest from the proposed assessment and the modified proposed assessment. Had Taxpayers desired to pay the tax on the federal retirement contribution amount they could have estimated that amount by subtracting the total interest on the modified proposed assessment (\$96.51) from the tax plus interest amount given in the Division's August 8, 2008 letter (\$264.69). Instead, in their August 24, 2008 letter Taxpayers estimated their costs of providing documentation and subtracted it from an estimated amount owed for the medical expense deduction. In fact, even after being provided with the tax only amount on the federal retirement contributions in the Division's April 10, 2009 memorandum, Taxpayers still have not paid the tax associated with the federal retirement contributions.

The Department may abate interest where it is found that such additional interest was due to an "unreasonable error or delay" by a Department employee, but "only if no significant aspect of the error or delay can be attributed to the taxpayer." While providing the information on tax only would have been preferable, based on the circumstances it was not unreasonable delay not to do so. Further, the delay in being given the information was due in significant part to the Taxpayers' communications. Taxpayers are not entitled to an abatement of interest under A.R.S. § 42-2065.

Based on the foregoing, the Hearing Officer's Decision and the modified proposed assessment for tax year 2003 are affirmed. Taxpayers are denied abatement of interest under A.R.S. § 42-2065. Taxpayers are entitled to a credit of \$61.44 for the payment made August 25, 2008.

ORDER

The Hearing Officer's decision is affirmed. Taxpayers are denied abatement of interest under A.R.S. § 42-2065.

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 15th Avenue, Suite 140 Phoenix, AZ 85007 or, if the amount in dispute is greater

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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 25th day of January, 2010.

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