

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)	DECISION OF
[REDACTED])	HEARING OFFICER
UTI # [REDACTED])	Case No. 201200089-I
_____)	

A hearing was held on May 15, 2012 in the matter of the protest of [REDACTED] (Taxpayers) to 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 2007.

This matter is ready for ruling.

FINDINGS OF FACT

1. Taxpayers timely filed an individual income tax return for tax year 2007 claiming a subtraction of \$[REDACTED] for interest Taxpayers received in connection with the purchase of property tax liens.
2. The Section reviewed Taxpayers' 2007 return and issued a proposed assessment dated January 25, 2012 disallowing Taxpayers' claimed subtraction.
3. The proposed assessment included corresponding interest. No penalties were assessed.
4. Taxpayers timely protested the assessment stating that the interest income is an obligation of Pinal, Gila and Maricopa Counties and is exempt from taxation by the State of Arizona.
5. Taxpayers reported the amount on their federal income tax return.
6. Taxpayers purchase property tax liens for unpaid property taxes.
7. Interest is paid to the purchaser of the tax lien when the owner redeems the lien.

8. The Department's instructions for Form 140, Line C29 provide in part:

D. Federally Taxable Arizona Municipal Interest

Enter the amount of any interest income received on obligations of the State of Arizona, or any political subdivisions of Arizona, that is included in your Arizona gross income. Do not enter any Arizona municipal interest that is exempt from federal taxation and not included in your federal adjusted gross income.

9. Taxpayers contend that because it is the counties' obligation to pay the interest to the purchaser of the tax lien when the lien is redeemed, the interest is exempt from state income tax under the Department's instruction for line C29.

CONCLUSIONS OF LAW

1. The burden is on the taxpayer to show he is 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).
2. Tax statutes are construed strictly against a party who claims a deduction, subtraction, exemptions or credit. *Arizona Department of Revenue v. Raby*, 204 Ariz. 509, 511, 65 P.3d 458 (App. 2002); *Davis v. Arizona Department of Revenue*, 197 Ariz. 527, 4 P.3d 1070 (App. 2000).
3. Arizona Revised Statutes (A.R.S.) § 43-1022 provides for subtractions from Arizona gross income.
4. There is no specific subtraction provided for federally taxable Arizona municipal interest in A.R.S. § 43-1022.
5. Art. 9, § 2 of the Arizona Constitution provides an exemption for public debts, as evidenced by the bonds of Arizona, its counties, municipalities or other subdivisions.

6. Interest earned on public debts, as evidenced by the bonds of Arizona, its counties, municipalities or other subdivisions, is exempt. *Continental Bank v. Arizona Dept. of Revenue*, 131 Ariz. 6, 638 P.2d 228 (App. 1981).
7. A tax that is levied on real or personal property is a lien on the assessed property. A.R.S. §§ 42-17153(A) and 42-17154(A).
8. Property taxes bear interest from the time of delinquency at the rate of sixteen per cent per year simple until paid. A.R.S. § 42-18053(A).
9. The county treasurer is required to secure the payment of unpaid delinquent property taxes by selling the tax lien on the property. A.R.S. § 42-18101(A).
10. The county treasurer sells the tax lien for the aggregate amount of all unpaid taxes that are delinquent on the property, together with all penalties, interest and charges respectively due for the current or preceding years. A.R.S. § 42-18104(B).
11. The tax lien is sold by the county treasurer to the person who pays the whole amount of delinquent taxes, interest, penalties and charges due on the property, and who in addition offers to accept the lowest rate of interest on the amount so paid to redeem the lien from the sale. A.R.S. § 42-18114.
12. The lien bears interest at the bid rate from the first day of the month following the purchase of the tax lien. A.R.S. § 42-18114.
13. The county treasurer distributes the monies collected from the sale of the tax lien in the same manner as property taxes are normally distributed. A.R.S. § 42-18123.
14. A real property tax lien that has been sold may be redeemed by the owner of the property, the owner's agent, assignee or attorney or any person who has a legal or equitable claim in the property. A.R.S. § 42-18151(A).

15. The real property tax lien may be redeemed within three years after the date of the sale, or thereafter if a treasurer's deed has not been delivered to the purchaser of the tax lien. A.R.S. § 42-18152.
16. Interest at the bid rate continues to accrue after the lien was sold until the lien is redeemed.
17. To redeem a tax lien, the owner must pay to the county treasurer the amount for which the real property tax lien was sold, plus interest at the rate stated in the certificate of purchase, taxes that accrued after the sale that were paid by the purchaser with interest on those taxes at the rate in the certificate or purchase and other fees paid by the purchaser. A.R.S. § 42-18153(A).
18. If the tax lien is properly redeemed, the county treasurer is required to issue a certificate or redemption to the person redeeming the tax lien. A.R.S. § 42-18154.
19. A.R.S. § 42-18155(A) provides that on "demand of any person who is entitled to redemption money held by the county treasurer, the treasurer shall pay the money to that person on the surrender of the certificate of purchase."
20. Because the delinquent taxes were paid when the property tax lien was sold, the county treasurer simply holds the funds it receives on the redemption of a tax lien and when demand is made, pays that amount to the person who had purchased the tax lien.
21. The interest included in the redemption amount is paid by the person redeeming the lien and is based on the interest rate stated in the certificate of purchase.
22. The Arizona Revised Statutes relating to the sale and redemption of property tax liens do not require the county treasurer to pay an interest amount independent of the redemption money he is holding.

23. The Arizona Revised Statutes relating to the sale and redemption of property tax liens do not involve public debts, as evidenced by the bonds of Arizona, its counties, municipalities or other subdivisions.
24. The interest component of the funds Taxpayers receive on the redemption of tax liens they purchased are not exempt from Arizona state income tax.
25. 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.
26. The Section’s proposed assessment dated January 25, 2012 was proper.

DISCUSSION

Taxpayers filed a resident Arizona individual income tax return and took a subtraction of \$[REDACTED] for interest Taxpayers received in connection with the purchase of property tax liens. The Section disallowed the subtraction. Taxpayers protested arguing that the subtraction is allowed under the Department’s instructions to Income Tax Form 140. The instructions provide a subtraction for interest income received on obligations of the State of Arizona, or any political subdivisions of Arizona, that is included in the taxpayer’s Arizona gross income and is not exempt from federal income tax.

A subtraction from tax must be based on some legal authority. There is no specific subtraction provided for federally taxable Arizona municipal interest in A.R.S. § 43-1022. Art. 9, § 2 of the Arizona constitution provides an exemption for public debts, as evidenced by the bonds of Arizona, its counties, municipalities or other subdivisions. The Arizona Court of Appeals has held that interest earned on public debts, as evidenced by the bonds of Arizona, its counties, municipalities or other subdivisions, is exempt. No other constitutional or statutory provision addressing interest paid on the sale and redemption of property tax liens has been cited.

Tax provisions are construed strictly against a party who claims a deduction, subtraction, exemptions or credit. The burden is on the taxpayer to show he is entitled to the deduction, subtraction, exemption or credit from tax. Thus the burden is on Taxpayers to show that the interest they received in connection with the purchase of property tax liens was interest earned on public debts evidenced by bonds of the state or one of its political subdivisions. Taxpayers have not met that burden.

Taxpayers' purchase of tax liens is a part of the mechanism to collect delinquent property taxes. Property taxes are a lien on the property and the lien may be sold if the taxes become delinquent. The purchaser of the tax lien must pay the delinquent taxes, penalties and interest. The county has now received its tax money and the purchaser of the tax lien holds a certificate of purchase. The certificate of purchase specifies how much interest the purchaser of the tax lien is willing to accept on his investment if the owner of the property should redeem the tax lien. That interest is a part of the redemption amount the owner is required to pay when he redeems the lien.

When the owner redeems the lien, he pays the redemption amount, including the interest that accrued after the sale of the tax lien, to the county treasurer. Because the delinquent taxes were paid, the county treasurer simply holds the redemption amount until the purchaser of the tax lien makes a demand for the money. When demand is made, the treasurer is required to pay the money to that person when he surrenders the certificate of purchase. There is no interest on a county obligation involved.

Taxpayers' argument appears to be that since the treasurer is required to pay the redemption money it is holding to the purchaser of the tax lien, including the interest component, the treasurer is obligated to pay the interest. Because the treasurer is obligated to pay Taxpayers the interest component the treasurer received when the lien was redeemed, the amount is interest on a county obligation. However, the interest component of the redemption amount is not interest payable on a county obligation, such as a bond. Taxpayers have cited no authority to the contrary.

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.

Based on the foregoing, the Section's proposed assessment dated January 25, 2012 is affirmed.

DATED this 27th day of June, 2012.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[REDACTED]
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