

5. The proposed assessment included interest but no penalties.
6. Taxpayers timely protested stating that they were required to repay the unemployment compensation to the State of Arizona.
7. The Arizona Department of Economic Security (DES) sent Taxpayers a Determination of Overpayment on January 7, 2010 informing Taxpayers that they were overpaid unemployment benefits of \$[REDACTED] during 2009.
8. Taxpayers did not appeal DES' overpayment determination.
9. DES received a tax refund offset from the Department in 2011 and a tax refund offset from the IRS in 2012. These two offsets paid Taxpayers' liability to DES for the overpayment in full.
10. In 2012 the Department also held Taxpayers' state refund for 2011 but then released the refund to Taxpayers after learning that the liability to DES had been satisfied.
11. The Department's problem resolution officer stated in a letter dated May 2012 that no money was due for 2009. At that time the proposed assessment had not yet been issued.

CONCLUSIONS OF LAW

1. The Arizona Legislature has the authority to levy and collect taxes, including income taxes. Ariz. Const. Art. 9, § 12.
2. At the time Taxpayers filed their return, Arizona gross income was defined as an individual's federal adjusted gross income computed pursuant to the Internal Revenue Code in effect on January 1, 2009, excluding any change to the Code enacted after January 1, 2009. A.R.S. §§ 43-105(A) and 43-1001(2).
3. Before the enactment of I.R.C. § 85(c) by the American Recovery and Reinvestment Act of 2009 on February 17, 2009, federal adjusted gross income included all unemployment compensation received by a taxpayer.

4. Taxpayers' Arizona gross income was therefore required to include the \$[REDACTED] of unemployment compensation they had received.
5. The amount of any item of gross income is required to be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. *See, Hope v. C. I. R.*, 471 F.2d 738 (C.A.3, 1973).
6. Taxpayers have not shown that the \$[REDACTED] of unemployment compensation was required to be included in income for a year other than 2009.
7. An exception may apply if in the year of receipt a taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provision for such repayment. *See, Hope v. C. I. R., supra.*
8. Here Taxpayers were not aware of the overpayment and did not recognize their liability to repay the amount until 2010 and did not repay the overpayment until 2011 and 2012.
9. A person who has to repay in a later year amounts he had received and held under a claim of right in previous years may deduct the repayment in the year in which it is made. I.R.C. § 1341 and A.R.S. § 43-1029.
10. Taxpayers are not entitled to a reduction of the proposed assessment for 2009 for repayments made in 2011 and 2012.
11. The Department issued Income Tax Procedure (ITP) 95-1 to address the procedure for individuals who restore substantial amounts held under a claim of right.
12. Under ITP 95-1, Taxpayers may file amended returns for 2011 and 2012 (the years of repayment) to increase their miscellaneous itemized deductions and claim refunds to the extent the deductions exceed two percent of Taxpayers' adjusted gross income for each year.

13. A notice of additional tax due may be issued by the Department within four years after a taxpayer filed the return or within four years after the due date of the return, whichever period is later. A.R.S. § 42-1104(A).
14. The due date for Taxpayers' return for tax year 2009 was April 15, 2010. A.R.S. § 43-325.
15. The proposed assessment for tax year 2009 issued November 14, 2013 was issued within the four-year statute of limitations.
16. 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.
17. A.R.S. § 42-1123(C) recognizes the time value of money, and thus requires a taxpayer that is holding or using money that rightfully belongs to the State to pay interest for the use of that money. *Valencia Energy Co. v. Arizona Dep't of Revenue*, 191 Ariz. 565, 959 P.2d 1256 (1998).
18. The Section's proposed assessment dated November 14, 2013 is affirmed.

DISCUSSION

Taxpayers timely filed their Arizona state income tax return for tax year 2009. A taxpayer's Arizona adjusted gross income is generally the same as a taxpayer's federal adjusted gross income as of a certain date, subject to modifications provided by statute. Taxpayers did not include in either their federal return or their state return unemployment compensation they had received during 2009. The Section issued a proposed assessment including in Taxpayers' income the unemployment compensation they had excluded. Taxpayers protested stating that they had to repay the unemployment compensation.

Taxpayers were notified in 2010 that they were required to repay to DES an overpayment of \$[REDACTED] of unemployment compensation. The overpayment was

repaid to DES through an income tax refund offset from the Department in 2011 and an income tax refund offset from the IRS in 2012. The two offsets paid Taxpayers' liability to DES in full.

The question presented is whether Taxpayers may reduce their income for tax year 2009 by the amount of the repayments they made in 2011 and 2012. Taxpayers were required to report income for the taxable year in which the income was received by Taxpayers (2009), unless in the year of receipt (2009) Taxpayers recognized their liability to repay the overpayment and made provisions for the repayment. Here, Taxpayers were not aware of the overpayment and did not recognize their liability to repay the amount until 2010 and did not repay the overpayment until 2011 and 2012. Taxpayers may not therefore reduce their income for 2009 by the repayments made in 2011 and 2012.

I.R.C. § 1341, and the corresponding Arizona provision, A.R.S. § 43-1029, allow a person who has to repay in a later year amounts he had received and held under a claim of right in previous years to deduct the repayment in the later year. Taxpayers may therefore file amended returns for 2011 and 2012 (the years of repayment) to increase their miscellaneous itemized deductions and claim refunds to the extent the deductions exceed two percent of Taxpayers' adjusted gross income for each year.²

The proposed assessment included interest pursuant to A.R.S. § 42-1123(C) which 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. Interest is not a penalty, but is compensation to the state for the lost time-value of money received after the due date. *Valencia Energy Co. v. Arizona Dep't of Revenue, supra*.

² Tax years 2011 and 2012 are not before the Hearing Office. We cannot address whether Taxpayers' miscellaneous itemized deductions on an amended return would exceed the 2% limitation or whether their itemized deductions would exceed the standard deduction.

Based on the foregoing, the Section's proposed assessment dated November 14, 2013 is affirmed.

DATED this 23rd day of October, 2014.

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