

ARIZONA DEPARTMENT OF REVENUE

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ARIZONA INDIVIDUAL INCOME TAX PROCEDURE ITP 00-1

Procedure for Requesting Relief from Joint and Several Liability

(This procedure supersedes ITP 97-3)

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 25-211 provides that all property acquired by either husband or wife during marriage is community property, except that which is acquired by gift or by inheritance.

A.R.S. § 42-1251 provides for appeal to the department for a hearing, correction or redetermination of a proposed assessment.

A.R.S. § 42-1253 provides for appeal to the state board of tax appeals of a final decision of the department.

A.R.S. § 42-2074 provides for equitable relief from joint and several liability under certain circumstances.

A.R.S. § 42-2201 provides for relief from joint and several liability on a joint income tax return when certain conditions are met.

A.R.S. § 42-2202 provides that a taxpayer who filed a joint income tax return may elect to limit his or her liability with respect to a deficiency assessed for that return when certain conditions are met.

A.R.S. § 43-301 sets forth the individual filing requirements and provides for joint and several liability in the case of a husband and wife who file a joint return.

A.R.S. § 43-309 allows married individuals to file joint income tax returns.

A.R.S. § 43-562 also provides for joint and several liability in the case of a husband and wife

OTHER LOCATIONS: Tucson Government Mall – 400 W. CONGRESS - TUCSON
East Valley – 3191 N. WASHINGTON STREET - CHANDLER
North Valley – 2902 W. AGUA FRIA FREEWAY - PHOENIX

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who file a joint return.

DISCUSSION:

Under Arizona's individual income tax filing provisions, married persons are given the option of filing a joint return. If a joint Arizona income tax return is filed, the tax liability on the aggregate income (community and separate income) is joint and several. When the income tax liability is joint and several, the department may proceed separately against either spouse or both spouses for the entire liability. However, in some cases, a spouse may be relieved of joint and several liability. Three types of relief are available.

1. Innocent spouse relief (A.R.S. § 42-2201).
2. Relief by separation of liability (A.R.S. § 42-2202).
3. Equitable relief (A.R.S. § 42-2074).

These relief provisions apply to any joint and several tax liability arising on or after August 6, 1999, and for any joint and several tax liability that remains unpaid as of August 6, 1999.

Innocent Spouse Relief

A spouse may qualify for innocent spouse relief from joint and several liability under A.R.S. § 42-2201 when the following conditions are met:

1. A joint Arizona income tax return was filed for the tax year for which relief is requested.
2. There is an understatement of tax attributable to erroneous items of the other spouse.
3. The innocent spouse did not know, and had no reason to know, that there was an understatement of tax when he or she signed the joint return.
4. Under the circumstances it would be inequitable to hold the innocent spouse liable for the deficiency resulting from the understatement of tax.

An erroneous item with respect to a spouse is any item of gross income attributable to that spouse which is omitted from gross income. The determination of the spouse to which income is attributable is made without regard to community property laws. For example, commissions earned by a wife from self-employment and omitted from the joint return are attributable only to the wife even though the commissions may constitute community income.

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An erroneous item with respect to a spouse also includes any claim for deduction, subtraction, credit, or basis claimed by that spouse in an amount for which there is no basis in fact or law. For example, a deduction has no basis in fact when the expense for which a deduction is claimed was never incurred.

An understatement of tax is generally the difference between the total amount of tax that should have been shown on the return and the amount of tax that was actually shown on the return.

An innocent spouse may qualify for partial relief if, at the time the return was signed, the innocent spouse knew or had reason to know that there was an understatement of tax due to the other spouse's erroneous items, but the innocent spouse did not know the full extent of the items. The innocent spouse may be relieved of part of the understatement of tax.

Relief by Separation of Liability

A taxpayer may qualify for relief from joint and several liability on a jointly filed return by making a separate liability election under A.R.S. § 42-2202 when **either** of the following conditions are met.

1. The taxpayer is no longer married to, or is legally separated from, the spouse with whom the taxpayer filed the joint return.
2. The taxpayer was not a member of the same household as the spouse with whom the joint return was filed at any time during the 12 month period ending on the date the separate liability election was filed with the department.

Under this relief, liability for an understatement of tax on a joint return may be allocated between the electing taxpayer and his or her spouse or former spouse. Items giving rise to the understatement of tax will be allocated to the taxpayers as if separate returns had been filed for the taxable year without regard to community property laws.

Even if a taxpayer meets the requirements mentioned above, a request for separation of liability will **not** be granted in the following situations:

1. The electing taxpayer and his or her spouse transferred assets as part of a fraudulent scheme.
2. The electing taxpayer had actual knowledge that any items giving rise to the deficiency and allocable to the taxpayer's spouse were incorrect. In this situation, the request will be denied only for the part of the deficiency which relates to the incorrect items of which the electing taxpayer had actual knowledge.

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3. The electing taxpayer transferred property to his or her spouse (or former spouse) just to avoid tax or the payment of tax.

Equitable Relief

A taxpayer who does not qualify for innocent spouse relief or separation of liability may be relieved of joint and several liability through equitable relief. A taxpayer may qualify for equitable relief under A.R.S. § 42-2074 if the following conditions are met.

1. The taxpayer is not eligible for innocent spouse relief under A.R.S. § 42-2201.
2. The taxpayer is not eligible for separation of liability under A.R.S. § 42-2202.
3. Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for an understatement or underpayment of tax.

Unlike innocent spouse relief or separation of liability, a taxpayer may obtain relief from joint and several liability on a joint return for an understatement of tax and also **an underpayment** of tax (tax shown on a return that was not paid) through equitable relief.

PROCEDURE:

I. Application for Relief

A taxpayer's request for innocent spouse relief, relief by separation of liability, or equitable relief must be in writing and must provide sufficient information to establish that the conditions prescribed for the relief requested have been met. Arizona Form 200 "Request for Innocent Spouse Relief And Separation of Liability and Equitable Relief" is provided for this purpose. To apply for relief, the taxpayer should submit a completed Arizona Form 200, together with the necessary information as follows:

- If the taxpayer is meeting with a department employee for an examination, appeal, or collection, the form may be submitted to that employee.
- If the taxpayer receives a department notice of deficiency, the form may be submitted to the department employee named in the notice. (Attach a copy of the notice.)

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- In all other situations the form should be submitted to:

Arizona Department of Revenue
P.O. Box 29081
Phoenix, AZ 85038-9081

Assistance in completing Form 200 may be obtained by contacting Taxpayer Information and Assistance at (602) 255-3381 or nationwide toll free at (800) 352-4090. A copy of the form is attached to this procedure. The form may also be obtained by calling (602) 542-4260.

When a taxpayer requests relief from joint and several liability, the department is required to notify the taxpayer's spouse or former spouse of the request. The department must also allow the other party to participate in the determination of the amount of relief from liability. Notification will be mailed to the other party's last known address as determined from department records or as shown on the taxpayer's Form 200.

II. Determination by the Department

The Individual Income Tax Audit Section (audit section) will review the taxpayer's Form 200 and determine whether the taxpayer qualifies for innocent spouse relief (A.R.S. § 42-2201) or relief by separation of liability (A.R.S. § 42-2202). The audit section may require the taxpayer to furnish additional information. The audit section may determine that the taxpayer qualifies for full relief from the understatement, that the taxpayer qualifies for partial relief, or that the taxpayer does not qualify for relief.

If the audit section determines that the taxpayer does not qualify for innocent spouse relief or relief by separation of liability, the audit section will review the taxpayer's Form 200 to determine whether the taxpayer qualifies for equitable relief under A.R.S. § 42-2074. The audit section may require the taxpayer to furnish additional information. Any recommendation by the audit section with respect to equitable relief will be reviewed by an Equitable Relief Review Committee of the department.

The department will notify the taxpayer requesting relief, and the other party, in writing with respect to the department's determination.

III. Review of Unfavorable Determination

A party who disagrees with the determination of the audit section with respect to innocent spouse relief, relief by separation of liability, or equitable relief may petition the department's Hearing Office for a review under A.R.S. § 42-1251. The petition must be in writing and must be submitted within 90 days of the mailing of the audit section's determination.

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The Hearing Office may affirm or reverse the audit section's determination, or may remand the request for relief back to the audit section with additional instructions. The Hearing Office will notify the taxpayer requesting relief, and the other party, in writing with respect to the determination on review.

A party who disagrees with a determination of the Hearing Office may appeal the determination to the Director of the Department of Revenue. The Director may also independently determine that a Hearing Office decision requires review. If no appeal is made to the Director within 30 days after the Hearing Office decision is received, and the Director does not independently review the decision, the Hearing Office decision is the final order of the department. If the decision is reviewed by the Director, the Director's decision is the final order of the department.

Either party may appeal a final order of the department (whether a Hearing Office decision or a Director's decision) to the State Board of Tax Appeals under A.R.S. § 42-1253.

Mark W. Killian, Director

Date

Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to department personnel. A tax procedure is a written statement issued by the department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.

**ADDENDUM
TO
ARIZONA INDIVIDUAL INCOME TAX PROCEDURE
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WORKSHEETS FOR FIGURING UNDERSTATEMENT OF TAX

INNOCENT SPOUSE (A.R.S. § 42-2201)

The department will figure the tax, interest, and penalties that qualify for relief after you file a completed Form 200 with all the required attachments. **You are not required to figure these amounts.** But if you wish, you can figure the understatement of tax yourself by using Worksheet 1. If you want to use Worksheet 1, you will need the following items.

- A copy of your tax return for the year(s) you are requesting relief.
- The tax return instructions for the year(s) you are requesting relief. The instructions have the tax table or tax rate schedule you will need.

Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**
(**Note.** This worksheet is optional. Keep it for your records.)

1. Enter your total tax including all changed items. 1. _____

Note. This should be shown on the department's notice or audit report.

2. Refigure your total tax by excluding adjustments relating to your spouse's erroneous items. Include items you knew about or had reason to know about 2. _____

3. **Tax eligible for innocent spouse relief.**
Subtract line 2 from line 1..... 3. _____

Example: John and Joan Smith filed a joint 1996 tax return (Form 140) in 1997. The total tax on the return was \$1,650 (taxable income of \$50,000). In 1999 the department audited their return and determined that John did not report \$10,500 in wages. On August 31, 1999 the department mailed the Smiths a Notice of Deficiency showing additional tax of \$441.

At the time Joan signed the return, she knew about \$5,500 of John's wages. She did not know about, and had no reason to know about, the other \$5,000. She believes it would be unfair for the department to make her responsible for the understatement of tax due to the \$5,000 of wages. Joan uses Worksheet 1 to figure the tax that qualifies for innocent spouse relief.

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Line 1: Joan enters \$2,091. This is the total tax as refigured by the department.

Line 2: \$1,881 is what the total tax would be by including only the unreported income that Joan knew about. She figures this amount as follows:

- 1. Taxable income shown on Joint Return \$50,000
- 2. Plus: John's unreported income that Joan knew about \$ 5,500
- 3. Refigured taxable income..... \$55,500
- 4. Refigured tax on \$55,500 from Table Y
in 1996 Form 140 instructions \$ 1,881

Line 3: Joan subtracts line 2 from line 1 to get the understatement of tax (\$210) due to the unreported wages she did not know about, and had no reason to know about. **This is the tax that is eligible for innocent spouse relief.**

Filled in Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**

(Note. This worksheet is optional. Keep it for your records.)

- 1. Enter your total tax including all changed items. 1. \$2,091

Note. This should be shown on the department's notice or audit report.

- 2. Refigure your total tax by excluding adjustments relating to your spouse's erroneous items. Include items you knew about or had reason to know about 2. \$1,881

- 3. **Tax eligible for innocent spouse relief.**
Subtract line 2 from line 1..... 3. \$ 210

Example: Jerry and Pat Green filed a joint 1996 tax return (Form 140) in 1997. The total tax on the return was \$1,650 (taxable income of \$50,000). Jerry and Pat claimed an enterprise zone credit for 1996 in the amount of \$1,500 for new employees hired for Jerry's business. In 1999, the department audited their return and determined that Jerry's business did not hire any new employees during 1996 and therefore, did not qualify for the enterprise zone credit. On September 30, 1999, the department mailed the Greens a Notice of Deficiency showing additional tax of \$1,500.

At the time Pat signed the return, she knew about the credit, but she was not involved in Jerry's business and did not know that Jerry's business did not hire any new employees during 1996. She believes it would be unfair for the department to make her responsible for the understatement of tax due to the disallowed credit. Pat uses worksheet 1 to figure the tax that qualifies for innocent spouse relief.

ADDENDUM

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Line 1: Pat enters \$1,650. This is the total tax as refigured by the department.

Line 2: \$150 is what the total tax would be by excluding the adjustment relating to Jerry's erroneous item (the enterprise zone credit).

Line 3: Pat subtracts line 2 from line 1 to get the understatement of tax (\$1,500) due to the disallowed credit. **This is the tax that is eligible for innocent spouse relief.**

Filled in Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**

(Note. This worksheet is optional. Keep it for your records.)

1. Enter your total tax including all changed items. 1. \$1,650

Note. This should be shown on the department's notice or audit report.

2. Refigure your total tax by excluding adjustments relating to your spouse's erroneous items. Include items you knew about or had reason to know about 2. \$ 150

3. **Tax eligible for innocent spouse relief.**
Subtract line 2 from line 1..... 3. \$1,500

SEPARATION OF LIABILITY (A.R.S. § 42-2202)

The department will figure your separation of liability and figure any related interest and penalties after you file a completed Form 200 with the required attachment. **You are not required to figure these amounts.** But if you wish, you can figure your separation of liability yourself by using Worksheet 2.

If you reported your child's tax liability on your joint return, do not include that liability when figuring your separation of liability. Allocate it as appropriate between you and your spouse.

When allocating income and deductions taken into account in computing the understatement of tax, allocate them in the same manner you would have allocated them if you and your spouse had filed separate returns without regard to community property laws.

Allocate wages and salaries to the spouse who performed the job and received the Form W-2. You generally allocate business and investment income (including capital gains) according to which spouse owned the business or investment that produced the income. Income from a jointly owned business or investment should be allocated equally between you and your spouse unless there is clear and convincing evidence that supports a different allocation.

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Allocate business deductions according to the ownership of the business. Allocate personal deductions (such as itemized deductions for mortgage interest and taxes) equally between you and your spouse unless there is evidence that shows a different allocation is appropriate.

An item that is otherwise allocable to one spouse must be allocated to the other spouse to the extent the item created a tax benefit for the other spouse.

Worksheet 2. **Worksheet for Figuring Your Separation of Liability**

(Note: This worksheet is optional. Keep it for your records.)

1. Enter the net amount of income and deductions taken into account in computing the understatement of tax and allocated to you 1. _____
2. Enter the net amount of **all** income and deductions taken into account in computing the understatement of tax* 2. _____
3. Divide line 1 by line 2. Enter the result as a decimal (rounded to at least 3 places)..... 3. _____
4. Enter the understatement of tax* 4. _____
5. Enter any credits taken into account in computing the understatement of tax and allocated to your spouse* 5. _____
6. Enter any credits taken into account in computing the understatement of tax and allocated to you* 6. _____
7. Add lines 5 and 6 7. _____
8. Subtract line 7 from line 4..... 8. _____
9. Multiply line 8 by line 3 9. _____
10. Add lines 9 and 6. This is the understatement of tax you are responsible for..... 10. _____

*This should be shown on the department's notice or audit report.

Example: Bob and Betty Brown filed a joint 1996 tax return (Form 140) in 1997. The total tax on the return was \$3,750 (taxable income of \$100,000). Bob and Betty were divorced in 1998. On August 31, 1999 the department audited their return and issued a Notice of Deficiency to the Browns relating to their 1996 return. There were four items listed on the notice.

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- \$20,000 of business expense deductions relating to Betty's real estate business were disallowed.
- \$7,000 of commissions were unreported by Betty.
- \$2,000 of business expense deductions relating to Bob and Betty's bookstore were disallowed.
- \$500 of interest income from an account that belonged to Bob was unreported.

Bob had no actual knowledge with respect to the deductions and commissions from Betty's real estate business. He decides to file Form 200 to request relief from the \$29,500 deficiency under separation of liability. He allocates the items between himself and Betty as follows (he attaches this allocation to his Form 200).

	Betty	Bob
Real estate business expense deduction	\$20,000	
Real estate commissions	\$ 7,000	
Bookstore expense deduction	\$ 1,000	\$ 1,000
Interest income		\$ 500

To determine the understatement of tax that is allocable to him, Bob fills out Worksheet 2 as follows:

Line 1: Bob enters one-half of the disallowed bookstore business expense deduction (\$1,000) and the unreported interest income (\$500).

Line 2: Bob enters the net amount of **all** income and deductions taken into account in computing the understatement of tax (\$29,500).

Line 3: Bob divides line 1 by line 2 to get .051.

Line 4: Bob enters the \$1,534 understatement of tax. This is shown on the department's Notice of Deficiency.

Lines 5, 6, and 7: Bob enters zero on these lines since there are no credits to be allocated.

Lines 8 – 10: Bob completes lines 8 through 10. Line 10 shows that he is responsible for \$78 of the understatement of tax. Betty is responsible for the remaining amount (\$1,456).

ADDENDUM

(Continued)

Filled in Worksheet 2. **Worksheet for Figuring Your Separation of Liability**

(Note: This worksheet is optional. Keep it for your records.)

1. Enter the net amount of income and deductions taken into account in computing the understatement of tax and allocated to you 1. \$ 1,500
2. Enter the net amount of **all** income and deductions taken into account in computing the understatement of tax* 2. \$29,500
3. Divide line 1 by line 2. Enter the result as a decimal (rounded to at least 3 places)..... 3. .051
4. Enter the understatement of tax* 4. \$1,534
5. Enter any credits taken into account in computing the understatement of tax and allocated to your spouse* 5. -0-
6. Enter any credits taken into account in computing the understatement of tax and allocated to you* 6. -0-
7. Add lines 5 and 6 7. -0-
8. Subtract line 7 from line 4..... 8. \$1,534
9. Multiply line 8 by line 3 9. \$ 78
10. Add lines 9 and 6. This is the understatement of tax you are responsible for..... 10. \$ 78

*This should be shown on the department's notice or audit report.