BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of [TAXPAYER] UTI # [REDACTED]	))))))	DECISION OF HEARING OFFICER Case No. 200600061-I

A hearing was held on June 20, 2006 in the matter of the protest of [REDACTED] (Taxpayer) to an assessment of income tax, penalties and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2000. The Section timely filed its post-hearing submission on July 5, 2006. Taxpayer timely filed her response on July 24, 2006. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

Based on information obtained from the Internal Revenue Service (IRS) through the Department's exchange of information agreement with that agency (I.R.C. § 6103(d)(1)), the Section audited Taxpayer's 2000 Arizona income tax return. The Section disallowed Taxpayer's subtraction of federal retirement contributions, medical expenses, interest expense and moving expenses. The Section accordingly issued a proposed assessment for 2000 on March 2, 2005 that included tax, a negligence and late payment penalty and interest. Taxpayer timely protested the assessment and provided additional information. The Section subsequently modified the assessment on November 23, 2005 to allow the medical expenses and to abate the negligence penalty.

On February 8, 2006 the Section modified the assessment again to allow $397.00 of investment interest expense and $10,194.45 of moving expenses. The issue is the propriety of the modified assessment dated February 8, 2006. At the hearing, the Section conceded that the late payment penalty should be abated.

CONCLUSIONS OF LAW

An assessment of additional income tax is presumed correct. *Arizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948). Taxpayer has provided insufficient evidence to prove that the Section's modified assessment dated February 8, 2006 is incorrect.

With regard to itemized deductions, the Arizona Revised Statutes provide at A.R.S. § 43-1042.A:

> 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, but subject to the limitations prescribed by §§ 67, 68 and 274, of the internal revenue code.

The Internal Revenue Code, at I.R.C. § 163(a), allows as a deduction all interest paid or accrued within the taxable year on indebtedness. I.R.C. § 163(d)(1) limits the amount of investment interest deductible by a taxpayer who is not a corporation to the amount of the taxpayer's net investment income for the taxable year. I.R.C. § 163(d)(4)(A) defines "net investment income" to mean the excess of investment income over

investment expenses. I.R.C. § 163(d)(4)(B) defines "investment income" to mean the sum of:

> (i) gross income from property held for investment (other than any gain taken into account under clause (ii)(I)),
> (ii) the excess (if any) of-
> (I) the net gain attributable to the disposition of property held for investment, over
> (II) the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment, plus
> (iii) so much of the net capital gain referred to in clause (ii)(II) (or, if lesser, the net gain referred to in clause (ii)(I)) as the taxpayer elects to take into account under this clause . . .

On her 2000 federal Schedule A, Taxpayer claimed $5,016 as a deduction for investment interest expense. The Section's position is that Taxpayer's investment income is only $397 in tax year 2000 and her investment interest expense deduction is limited to that amount. The key issue is whether capital loss carryovers from prior years are taken into account in determining "investment income" under I.R.C. § 163(d)(4)(B). On her 2000 federal Schedule D, Taxpayer reported total capital gains and distributions of $7,633, a long-term capital loss carryover of $16,406 and a net long-term capital loss of $13,295.

In calculating "investment income," I.R.C. § 163(d)(4)(B)(ii) directs one to take into account the net gain attributable to the disposition of investment property and the net capital gain determined by only taking into account gains

and losses from dispositions of property held for investment. Based on the foregoing, it is reasonable to conclude that a taxpayer must take into account capital loss carryovers from prior years in completing federal Form 4952 ("Investment Interest Expense Deduction"). This is confirmed by the instructions to the 2005 federal Form 4952. Additionally, the U.S. Tax Court addressed this same issue in a case remarkably similar to the present one. In *Paul S. Talchik v. Commissioner*, T.C. Memo 2003-342 (2003), the Court agreed with the IRS that the petitioners had no investment income in excess of the dividend and interest income of $225 since their short-term and long-term capital gains for 1999 (the year at issue) were totally offset by capital loss carryovers from 1998. The Court held that the IRS correctly allowed the petitioners an investment interest expense deduction equal to $225, the amount of petitioners' interest and dividend income, and that the IRS correctly disallowed the petitioners' investment interest deduction to the extent the deduction exceeded their net investment income. The Court determined that during 1999 the petitioners did not realize any income that would be considered net income attributable to the disposition of property held for investment because the carryover losses from 1998 totally offset the capital gains the petitioners realized during 1999.

In light of the foregoing, the Section properly concluded that Taxpayer's investment income for 2000 is only $397 and Taxpayer's investment interest expense deduction is limited to that amount. At the hearing, Taxpayer testified that she spoke

with an IRS employee on March 2, 2006 who informed her that the investment interest expense deduction is not reduced by offsetting or subtracting a capital loss carryover from a prior year on federal Form 4952 against tax year 2000 income that Taxpayer had from stock sales, and that the method Taxpayer used to compute the net capital gain amount was correct. It is unknown why this IRS employee made such a statement in light of the Court's contrary decision in *Talchik*. It is also unknown why the IRS made no changes to Taxpayer's 2002 federal income tax return.

I.R.C. § 217 allows a deduction as an adjustment to gross income for certain moving expenses paid or incurred during the taxable year in connection with the commencement of work by a taxpayer as a self-employed individual or as an employee at a new principal place of work. In its post-hearing submission, the Section points out that Taxpayer deducted $13,380.00 for moving expenses on line 26 of her 2000 federal income tax return. Concerning moving expenses, the Section states in its post-hearing submission:

> The documentation received from Taxpayer verifies less than $6,000.00 . . . of deductible moving expenses. Taxpayer states that she opted to take a *per diem* rate through her employer. Attached to and reported as income on her return is a separate W-2 form showing the payment of moving expenses by her employer in the amount of $10,194.45. On the second modification, Income Audit allowed the reimbursement from the employer as if the entire amount qualifies as deductible moving expenses.

Taxpayer has provided insufficient evidence to prove that she is entitled to claim moving expenses in an amount greater than the $10,194.45 allowed by the Section in the modified assessment dated February 8, 2006.

With regard to Taxpayer's subtraction of federal retirement contributions, in *Kerr v. Killian*, 207 Ariz. 181, 84 P.3d 446 (2004), the Arizona Supreme Court found in favor of the Department and against the federal employees with regard to taxation of federal employee retirement contributions for tax years after 1990. In its decision, the Court held that the state income tax code does not discriminate against federal employees because of the source of their pay or compensation and thus does not violate the intergovernmental tax immunity doctrine codified in 4 U.S.C. § 111(a). The plaintiffs in *Kerr* subsequently filed a Petition for Writ of Certiorari with the United States Supreme Court, which the United States Supreme Court denied. *See Moran v. Hibbs*, 125 S.Ct. 39 (2004). There are no further appeals available and the issues for tax years after 1990 presented in *Kerr* are finally resolved. Therefore, the Section properly disallowed the subtraction.

Taxpayer asserts that she is entitled to a refund of Arizona income tax paid on her federal employee retirement contributions for tax years 1988, 1989 and 1990. However, the only issue properly before the Hearing Office in this case is the assessment issued for tax year 2000. Other years and issues may not be addressed in this case. However, in footnote 5 to the Section's post-hearing submission, the Section states that

"it appears that Taxpayer will benefit from pending litigation and a proposed settlement of this litigation."

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. The tax was due in this case and the associated interest cannot be abated.

Based on the foregoing, the Section's modified assessment dated February 8, 2006 is affirmed except that the late payment penalty must be abated, as conceded by the Section at the hearing.

DATED this 31st day of July, 2006.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[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