STATE OF ARIZONA

Department of Revenue
Office of the Director
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Janet Napolitano
Governor

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Director

CERTIFIED MAIL [redacted]

The Director's Review of the Decision of the Hearing Officer Regarding:	)	**O R D E R**
[redacted]	)	**Case No. 200600155 -I**
UTI: [redacted]	)	

On February 22, 2007 the Hearing Officer issued a decision regarding the protest of [redacted] ("Taxpayer"). Taxpayer appealed this decision on March 22, 2007. 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") issued deficiency assessments to Taxpayer for tax years 2000 and 2001, denying all itemized deductions, but allowing a standard deduction, and denying a credit for contribution to a school tuition organization. Taxpayer protested the assessment, provided additional information and modified assessments were issued twice, resulting in allowing all itemized deductions except those claimed for personal property taxes, certain charitable deductions and medical expense deductions for a swimming pool.

Taxpayer continued in his protest, a hearing was held, and the Hearing Officer denied the protest. On appeal, Taxpayer maintains that he is entitled to more itemized deductions than allowed in the modified assessments. In all the documents he has presented either to the Hearing Office or on appeal the only deductions Taxpayer has addressed are those for personal property tax, for charitable contributions and for medical expenses.[1] Taxpayer

[1] In his appeal Taxpayer also states that the Hearing Officer entered a default judgment against him. Taxpayer elected to have his hearing by memoranda and submitted his opening memorandum. Subsequently the Division submitted its

also maintains he should be allowed to change his filing status to married filing jointly. The Division argues that Taxpayer has been allowed all deductions for which he has provided proof of entitlement and that Taxpayer request for change in filing status was made too late.

Findings of Fact

The Director adopts and incorporates into this order the findings of fact set forth in the decision of the Hearing Officer and supplements with additional findings as follows:

1. Taxpayer timely filed his 2000 and 2001 Arizona income tax returns as married filing separate and paid what was shown as due on the returns.
2. On January 6, 2005, Division issued proposed assessments for 2000 and 2001, and modified these assessments twice, the last time on February 15, 2006 (current assessments).
3. For tax year 2000 Taxpayer claimed $1565 as deductions for charitable contributions, providing as the only documentation a report from what appears to be a computerized bookkeeping system for a total of $235 to two churches and a donation receipt from Good Will which appears to have had the date altered.
4. The Division disallowed the entire $1565 deduction.
5. For tax year 2001 Taxpayer claimed $800 of charitable contributions.
6. The only evidence of contributions made in 2001 was a receipt for a contribution of $600 to a private school tuition organization.
7. Taxpayer appears to have claimed this $600 both as a part of his itemized deductions for charitable contributions and a $500 credit for contributions to private school tuition organizations.

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response memorandum. While the record reflects the Division mailed its memorandum to Taxpayer at the address from which he filed his notice of appeal, on January 30, 2007, the day before his reply memorandum was due, Taxpayer sent a letter to the Hearing Officer stating he had not received a memorandum from the Section. On February 2, 2007, the Hearing Officer issued an order extending the period in which Taxpayer had to file his reply memorandum to February 16, 2007, and attached a copy of the Division's memorandum to that order. The record reflects that Taxpayer did not file a reply memorandum. Taxpayer was given adequate opportunity to participate in the hearing and did participate. The Decision of Hearing Officer is not a default judgment. Similarly, Taxpayer submitted his Notice of Appeal and the Division submitted its response memorandum, showing it mailed a copy to the Taxpayer. Taxpayer was given until May 29, 2007 to submit a reply memorandum. As of the date hereof, Taxpayer has not submitted a reply.

8. The Division allowed the credit of $500 and a total charitable contribution deduction of $100 for 2001.
9. In a letter dated March 26, 2005 from the Taxpayer, in addressing his deductions for personal property tax expense he described large purchases for both 2000 and 2001 on which he said he paid sales tax.
10. Taxpayer states he lost some of his records during a move.
11. Taxpayer provided no other evidence of personal property expense.
12. The Division disallowed the personal property deductions Taxpayer took in both 2000 and 2001.
13. Taxpayer claimed the cost of $23,982 for installing a pool at his house as medical expenses in 2000; no other medical expenses were claimed in either year.
14. Taxpayer claims the value of his home increased from $128,000 which purchased in 1994 to $257,000 when sold in 2003.
15. There is no evidence presented as to what impact the pool had on this appreciation.
16. Taxpayer claims he had an appraisal prior to the pool being installed in order to obtain a loan and at least one after the pool was installed, but has not provided the Department with a copy of any appraisal.
17. On March 16, 2006, Taxpayer made a request to change his filing status for 2000 and 2001 to married filing joint.

Conclusions of Law

The Director adopts and incorporates into this order the conclusions of law set forth by the Hearing Officer and supplements with additional conclusions as follows:

1. With regard to itemized deductions, 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, but subject to the limitations prescribed by §§ 67, 68 and 274, of the internal revenue code.

2. I.R.C. §§ 164, 170 and 213 are found in subtitle A, chapter 1, subchapter B, parts VI and VII, respectively; therefore, the deductions provided by this statute are available to taxpayers to take on their Arizona returns.
3. I.R.C. § 164(a) allows a deduction for certain taxes, including personal property tax. The term "personal property tax" means an ad valorem tax (based on the value of the property) which is imposed on an annual basis with respect to personal property. I.R.C. § 164(b) (1).
4. Ad valorum tax is a tax imposed on the value of property. *Black's Law Dictionary*, (6th ed. 1990) p. 51.
5. Sales tax is a tax on the retail sale of specified property or services. *Black's Law Dictionary*, (6th ed. 1990) p. 1339. Arizona has a tax similar to a sales tax, a transaction privilege tax, which is a tax on the business of selling tangible personal property at retail. A.R.S. § 42-5061(A).
6. Sales tax and transaction privilege tax are not ad valorem taxes.
7. Other than his written representations that he made some large purchases of personal property, Taxpayer provided no evidence of personal property tax expenses.
8. With regard to recordkeeping, Arizona law requires taxpayers to 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). A.R.S. § 42-1104 (A) establishes a general four-year statute of limitations.
9. The Division properly disallowed the personal property tax deduction taken in 2000 and 2001.
10. I.R.C. § 213 provides a deduction for part of the medical expenses not compensated for by insurance or otherwise.
11. A capital expenditure for permanent improvement of property which would not ordinarily be for the purpose of medical care may qualify as a medical expense to

the extent that the expenditure exceeds the increase in the value of the related property, if the particular expenditure is related directly to medical care. Treas. Reg. § 1.213-1 (e) (1) (iii).

12. Taxpayer did not provide any appraisals of his home to prove that the cost of a swimming pool he claimed to have installed for his wife for medical reason exceeded the increase in value of the home due to the pool.

13. Taxpayer did not establish he was entitled to a medical expense deduction for the installation of a swimming pool.

14. A.R.S. § 43-311(C) provides in pertinent part:

> A joint return may not be made under subsection A of this section:
>
> 1. After the expiration of four years from the last date prescribed by law for filing the return for such taxable year, determined without regard to any extension of time granted to either spouse.
>
> 2. After there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under § 42-1108, if the spouse, as to such notice, appeals to the department under § 42-1251, or appeals to the state board under § 42-1253.

15. A deduction for charitable contributions is allowed under I.R.C. §170.

16. Taxpayer provided no credible evidence of charitable contributions in 2000; therefore, the Division properly denied the entire deduction.

17. The only evidence of a charitable contribution for 2001 was $600 of contributions to a school tuition organization.

18. The credit for contributions to school tuition organizations is in lieu of any deduction pursuant to I.R.C. §170. A.R.S. § 43-1089 (D).

19. A.R.S. § 43-1021(22) provides that a taxpayer must add back to Arizona gross income any amount deducted pursuant to I.R.C. §170 representing contributions to a school tuition organization or a public school for which a credit is claimed under A.R.S. § 43-1089.

20. Because Taxpayer had claimed a credit for contribution to a school tuition organization for $500 based on the $600 contribution, the Division properly reduced the allowable itemized deduction for charitable contributions by $500.
21. The Division properly determined Taxpayer was entitled to an itemized deduction for charitable contributions for only $100 in 2001.
22. For Arizona purposes 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. A.R.S. § 42-1123. Interest cannot be abated in this case.
23. The late payment penalty may be abated upon a showing that the failure to timely pay is due to reasonable cause and not due to willful neglect. *See,* A.R.S. § 42-1125(D). Taxpayer provided no evidence of reasonable cause to abate.
24. The modified assessments dated February 15, 2006 are correct.

Discussion

Taxpayer timely filed his 2000 and 2001 Arizona income tax returns as married filing separate. Upon auditing the Division disallowed the itemized deductions claimed by Taxpayer for each year and instead allowed the standard deductions of $3600 and $4050, respectively. The Division also disallowed the $500 credit that Taxpayer claimed on his 2001 Arizona return for contributions to school tuition organizations. The Division issued proposed assessments on January 6, 2005 for 2000 that included tax, interest and a late payment penalty and for 2001 included tax and interest. Taxpayer timely protested the assessments. Based on additional information provided, the Division subsequently modified the assessments twice. In the second modified assessment, dated February 15, 2006, the Division allowed the $500 credit for contributions to school tuition organizations for 2001 and allowed all itemized deductions except for (1) all the personal property tax expenses claimed for both years, (2) all the medical expenses claimed in 2001, (3) all the charitable contributions claimed in 2000 and (4) $700 of the $800 of charitable contributions claimed in 2001. On appeal Taxpayer disputes the deductions disallowed.

A taxpayer may elect to itemize deductions pursuant to A.R.S. § 43-1042 (A) or to take the standard deduction provided by A.R.S. § 43-1041. Taxpayer chose to itemize

deductions on his 2000 and 2001 returns. A.R.S. § 43-1042(A) allows taxpayers to use, subject to the limitations prescribed by I.R.C. §§ 67, 68 and 274, the itemized deductions provided in subtitle A, chapter 1, subchapter B, parts VI and VII of the internal revenue code, which includes I.R.C. §§ 164 , 170 and 213.

Deduction for Personal Property Tax

On both his 2000 and 2001 Arizona returns Taxpayer took a deduction for personal property tax. I.R.C. § 164(a) allows a deduction for certain taxes, including personal property tax. The term "personal property tax" is an ad valorem tax which is imposed on an annual basis with respect to personal property. I.R.C. § 164(b) (1). Ad valorum tax is a tax imposed on the value of property. *Black's Law Dictionary*, (6th ed. 1990) p. 51.

In a letter dated March 26, 2005, Taxpayer explained that certain records were lost in a move. He then provided information from memory. He described purchases of motor vehicles and other expensive items in both 2000 and 2001 on which he said he paid sales tax. Sales tax is a tax on the retail sale of specified property or services. *Black's Law Dictionary*, (6th ed. 1990) p. 1339. Arizona has a tax similar to a sales tax, a transaction privilege tax, which is a tax on the business of selling tangible personal property at retail. A.R.S. § 42-5061(A). Sales tax and transaction privilege tax are not ad valorem taxes. An example of an ad valorem tax for personal property is tax on the value of motor vehicles, which is imposed annually in Arizona. Correspondence from an auditor indicates this was explained to Taxpayer. Taxpayer claims to have had motor vehicles during this period so may well have paid such a tax; however, he did not provide proof of payment.

With regard to recordkeeping, Arizona law requires taxpayers to 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." *See* A.R.S. § 42-1105.D. Taxpayer may have been mistaken as to the type of tax to deduct at the time he filed his return or he may have understood then, but lost the documentation. In either case Taxpayer has not established a right to claim personal property tax deductions for either 2000 or 2001.

Deduction for Medical Expenses

On his 2000 Arizona return Taxpayer took a deduction for medical expenses. A deduction for expenses paid for medical care is allowed under I.R.C. § 213. The item at issue for medical expenses is the cost of a swimming pool installed at Taxpayer's home. The Division disallowed the deduction in full.

Assuming without deciding that the installation of the swimming pool otherwise qualified as a medical expense, Treas. Reg. § 1.213-1(e)(1)(iii) provides in pertinent part:

> . . . a capital expenditure for permanent improvement or betterment of property which would not ordinarily be for the purpose of medical care (within the meaning of this paragraph) may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property, if the particular expenditure is related directly to medical care. . .

Taxpayer argues that the value of his home increased from $128,000 when purchased in 1994 to $257,000 when sold in 2003. If all of the increase was attributable to the pool, the expenditure would not have exceeded the increase in the value it adds to the property. However, increase could be attributable to other improvements or general market appreciation. There is no evidence presented as to what impact the pool had on this appreciation. The usual way to provide proof regarding increase in value of property is to provide an appraisal of the property just prior to the installation of the pool and another appraisal of the property just after the installation. While Taxpayer claims he had an appraisal before the pool was installed in order to obtain a loan and that he had at least one thereafter, he has not provided such appraisals or any other evidence of what affect the pool had on the value of the property. Taxpayer has not provided sufficient evidence to establish that there was any excess of expense for the pool over the increase in value of the property. The Division properly denied a deduction for the pool expenses.

Taxpayer requested that his filing status be changed from married filing single to married filing joint. He made this request in response to the Division's argument that he could not take a deduction for his wife's medical expenses because she was not a dependent on his tax return. Even if Taxpayer's wife were to join in this request, as the

foregoing states, the medical expense deduction for the installation of the pool is properly denied for other reasons.

There are two reasons it is not possible to make a change in filing status. A.R.S. § 43-311(C) provides in pertinent part:

> A joint return may not be made under subsection A of this section:
>
> 1. After the expiration of four years from the last date prescribed by law for filing the return for such taxable year, determined without regard to any extension of time granted to either spouse.
>
> 2. After there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under § 42-1108, if the spouse, as to such notice, appeals to the department under § 42-1251, or appeals to the state board under § 42-1253.

The first reason is that under A.R.S. § 43-311(C)(1), a request of a change in filing status must be made prior to the expiration of four years from the due date of return, without regard to extensions. That period expired for 2000 on April 15, 2005. Taxpayer made the request on March 16, 2006. A.R.S. § 43-311(C) (1) prevents changing status for 2000. The second reason is that Taxpayer was mailed notices of deficiency for 2000 and 2001 under A.R.S. § 42-1108 and Taxpayer appealed to the Department under A.R.S. § 42-1251. Therefore, A.R.S. § 43-311(C) (2) prohibits the changing filing status to joint for both 2000 and 2001. Taxpayer cannot change his filing status for either 2000 or 2001.

Deductions for Charitable Contributions

For tax year 2000 Taxpayer claimed $1565 as deductions for charitable contributions, which are deductible under I.R.C. §170. The only documentation provided for these contributions were a report from what appears to be a computerized bookkeeping system for a total of $235 to two churches and a donation receipt from Good Will which appears to have had the date altered. The Division properly disallowed the entire $1565 deduction.

For tax year 2001 Taxpayer claimed $800 of charitable contributions. The only evidence of contributions made in 2001 was a receipt for a contribution of $600 to a private

school tuition organization. Without further documentation of charitable contributions it was proper for the Division to reduce the deduction from $800 to $600.

Taxpayer appears to have claimed this $600 both as a part of his itemized deductions for charitable contributions and for the $500 credit for contributions to private school tuition organizations. A.R.S. § 43-1089 (D) provides that the credit for contributions to school tuition organizations is in lieu of any deduction pursuant to I.R.C. §170. Furthermore, A.R.S. § 43-1021(22) provides that a taxpayer must add back to Arizona gross income any amount deducted pursuant to I.R.C. §170 representing contributions to a school tuition organization or a public school for which a credit is claimed under A.R.S. §§ 43-1089 or 43-1089.01. Because Taxpayer claimed and the Division allowed the credit of $500, it was proper to reduce the charitable contribution deduction by another $500 to $100.

The late payment penalty may be abated only upon a showing that the failure to timely pay is due to reasonable cause and not due to wilful neglect. *See* A.R.S. § 42-1125 (D). "Reasonable cause" is generally defined to mean the exercise of "ordinary business care and prudence." *Daley v. United States,* 480 F. Supp. 808 (D.N.D. 1979). Taxpayer did not provide evidence of or argument regarding reasonable cause. Therefore, the imposition of the late payment penalty for tax year 2000 must be upheld.

As to the interest portion of the assessments, 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 Division's modified assessments dated February 15, 2006 were proper.

O R D E R

The Hearing Officer's decision is affirmed.

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 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 30th day of August 2007.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified originals of the foregoing
mailed to:

[redacted]

cc: Individual Income Protest Section
Individual Income Tax Section
Audit Division

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