

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)	DECISION OF
)	HEARING OFFICER
[Redacted])	
)	Case No. 200700156-I
UTI # [Redacted])	
_____)	

A hearing was held on January 16, 2008 in the matter of the protest of [Redacted] (Petitioner) to assessments of income tax, penalties and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for the tax years 2000, 2001, 2002, 2003 and 2004. The record in this matter was left open to allow Petitioner to provide W-2 documentation for tax years 2000, 2001, 2002, 2003 and 2004, and the Section time to review the documentation in order to determine whether modifications to the assessments were warranted. Petitioner timely submitted W-2s for some of the years at issue. Based on the information received, the Section issued modified proposed assessments on February 13, 2008, and allowed Petitioner 30 days to file a response. As of this date, Petitioner has not filed a reply memorandum. A reasonable amount of time has passed to allow Petitioner to file this memorandum. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

Based on information received from the Internal Revenue Service (IRS) through an exchange of information agreement with that agency, (I.R.C. § 6103(d)(1)), the Section determined that Petitioner had taxable income but failed to file Arizona income

tax returns for 2000, 2001, 2002, 2003 and 2004. The IRS information indicated that Petitioner had wage income for the years at issue. Based on the IRS information, the Section issued proposed assessments to Petitioner for the 2000, 2001, 2002, 2003 and 2004 tax years. The proposed assessments included tax, interest and penalties for failure to file when due.

Petitioner timely protested the assessments on the basis that he has never owed federal income tax. In his protest, he asserted that Arizona income tax is based on the federal income tax. Therefore, he reasoned that since he did not owe federal income taxes, he did not owe Arizona income tax. Petitioner stated that according to his reading of the law, there is no law that requires him to file a return. He also argued that he had no income as that term is defined for taxing purposes, specifically referring to Internal Revenue Code (I.R.C.) § 861. Further, Petitioner has argued that income taxes are based on voluntary compliance and self assessment and that he did not assess himself because he had no income to report.

On September 11, 2007, Petitioner filed Arizona resident income tax returns and federal Forms 4852 (substitute W-2 forms) for tax years 2000, 2001, 2002, 2003 and 2004. All of the income tax returns filed on September 11, 2007, listed zero amounts of adjusted gross income.

At the hearing, Petitioner reiterated some of his written arguments, and also declared that because he is not a public employee, he did not receive any wages that are subject to tax

under the I.R.C. The Section argued that Petitioner received compensation for services and that such compensation constitutes gross income as defined in the I.R.C.

The Section also stated at the hearing that if Petitioner would be willing to provide documentation (such as W-2s) showing that he had Arizona taxes withheld, they would be willing to credit such amounts toward taxes due. In addition, the Section agreed to allow Petitioner a deduction for Social Security retirement benefits to the extent they were included in his Federal Adjusted Gross Income (FAGI).

After the hearing, Petitioner submitted W-2s to the Section for some of the years at issue. Based upon the information received from Petitioner, the Section issued modified proposed assessments on February 13, 2008, for tax years 2000, 2001, 2002, 2003 and 2004. Each of the modified assessments allowed a credit for either actual or estimated Arizona income tax withheld, and each resulted in a net decrease in the amount of tax due for every year at issue. Pursuant to the January 17, 2008 Order issued by the Hearing Office, Petitioner was given until March 3, 2008 to respond to the modified assessments. However, the modified assessments themselves stated that the Section requested a response from Petitioner by March 14, 2008 indicating whether or not Petitioner agreed or disagreed with the modified assessments. As of this date, no response has been provided by Petitioner. At issue is the propriety of the modified assessments.

CONCLUSIONS OF LAW

The U.S. Constitution grants various powers to the federal government or the several states; however, a state's power to do a particular act need not be expressly granted by the U.S. Constitution in order for it to exist. The Tenth Amendment makes clear there are unstated powers and rights reserved to the people and the states:

The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

U.S. CONST. amend. X.

The Arizona Court of Appeals has noted that the State of Arizona's power to tax is independent of the Constitution of the United States. *Department of Revenue v. Arthur*, 153 Ariz. 1, 734 P.2d 98 (App. 1986). Article 9, § 12 of the Arizona Constitution extends to the Arizona Legislature the authority to levy and collect taxes, including income taxes. Pursuant to that authority, the Arizona Legislature enacted the Arizona Income Tax Act of 1978, effective as of January 1, 1979.

A.R.S. § 42-1004.A, which is titled "General powers and duties of the department...", states that "[t]he department shall administer and enforce the provisions of this title, title 43 and other laws assigned to it and has all the powers and duties prescribed by law for such purposes..." Some of those powers and duties include issuing deficiency assessments (A.R.S. § 42-1108), estimating tax owed (A.R.S. § 42-1109) and resolving protests (A.R.S. § 42-1251).

A.R.S. § 43-102.A.4 states that “[i]t is the intent of the legislature...[t]o impose on each resident of this state a tax measured by taxable income wherever derived.” A.R.S. § 43-104.19(a) provides that “resident” includes every individual who is in Arizona for other than a temporary or transitory purpose. A.R.S. § 43-104.19(b) states that “resident” includes every individual domiciled in Arizona who is outside Arizona for a temporary or transitory purpose. Petitioner has produced no evidence to show that he was not a resident of Arizona during 2000, 2001, 2002, 2003 and 2004. It must be concluded that Petitioner was a resident of Arizona during these years. Therefore, pursuant to A.R.S. § 43-102.A.4, all of his income wherever derived was subject to Arizona tax.

The United States Supreme Court has reiterated the well established principle of taxation that a state may tax all the income of its residents:

“That the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized. Domicil itself affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws are inseparable from responsibility for sharing the costs of government These are rights and privileges which attach to domicil within the state Neither the privilege nor the burden is affected by the character of the source from which the income is derived.”

Oklahoma Tax Commission v. Chickasaw Nation, 515 U.S. 450, 463 (1995) (quoting *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312-313 (1937)).

Petitioner asserts that he owes no Arizona income tax because he owes no federal income tax. However, as stated above, the State of Arizona's power to tax is independent of the Constitution of the United States. *Arthur*, 153 Ariz. at 3. Likewise, it is not dependent upon the Internal Revenue Code. The state's independence to tax includes the ability to determine how the tax is to be calculated. *Id.* The references to the Internal Revenue Code in A.R.S. § 43-1001, *et seq.*, are limited to the method used to calculate "gross income." These references do not require that the taxpayer ultimately owe any tax to the federal government. *Id.*

In his protest, Petitioner asserts that there is no law that requires him to file a tax return. However, A.R.S. § 43-301.A, as it existed for the years at issue, provides that an individual whose income is taxable under Title 43 shall file an Arizona return if he or she has Arizona adjusted gross income of \$5,500 or more if single, or gross income of \$15,000 or more regardless of the amount of taxable income. Petitioner's income for the years at issue was above these amounts. Therefore, A.R.S. § 43-301.A required Petitioner to file Arizona returns for the years at issue.

Petitioner also asserts that, according to the law, he is the only one who can determine whether or not he had taxable income. However, A.R.S. § 42-1108 states in part as follows:

A. If a taxpayer fails to file a return required by this title or title 43, or if the department is not satisfied with the return or payment of the amount of tax required to be paid under either title, the

department may examine any return, including any books, papers, records or memoranda relating to the return, to determine the correct amount of tax. This examination must occur within the time periods prescribed by § 42-1104 and may be accomplished through a detailed review of transactions or records or by a statistically valid sampling method.

Thus, pursuant to A.R.S. § 42-1108, the Section clearly had authority to perform its examination of any available records and to issue the proposed assessments for the years at issue.

Based upon the information available, the Section determined that Petitioner received gross income by receiving compensation from performing labor or services. The Internal Revenue Code, at I.R.C. § 61(a), provides that "gross income" means all income from whatever source derived, and includes, among other items, compensation for services, commissions, gross income derived from business, interest, rents, royalties, dividends and pensions. It is an established principle of federal tax law that absent an enumerated exception, gross income means all income from whatever source. It is also well settled that all realized accessions to wealth are presumed to be taxable income unless a taxpayer can demonstrate that an acquisition is specifically exempted or excluded. *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994). Clearly, the compensation that Petitioner received for his labor falls within this definition of "gross income."

Courts have consistently and unequivocally rejected arguments that compensation is not taxable income. In *United States v. Lawson*, the Tenth Circuit Court of Appeals held that:

[W]ages for personal services are income under the Internal Revenue Code Notwithstanding [taxpayer]'s belief that his wages are not gains or profits but merely what he has received in an equal exchange for his services, the Internal Revenue Code clearly includes compensation of this nature within reportable gross income.

670 F.2d 923, 925 (10th Cir. 1982); see also *Arthur*, 153 Ariz. 1, 734 P.2d 98 (holding that wages are income for purposes of the Arizona personal income tax).

At the hearing, Petitioner maintained that he did not receive wages because he is not an "employee" as that term is defined in the code, and added that he has never worked for the state or federal government. Petitioner did not cite a statute or law upon which he relied for this argument. However, other taxpayers have relied upon I.R.C. § 3401 in making similar arguments. I.R.C. § 3401(c) states in part:

EMPLOYEE.- For purposes of this chapter, the term "employee" includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. The term "employee" also includes an officer of a corporation.

The courts have consistently rejected the argument that only government officers or workers are "employees" as defined in statute. Facing a similar argument, the First Circuit Court of Appeals imposed sanctions on the taxpayer for bringing a frivolous appeal, and stated:

To the extent Sullivan argues that he received no "wages" in 1983 because he was not an "employee" within the meaning of 26

U.S.C. § 3401(c), that contention is meritless. Section 3401(c), which relates to income tax withholding, indicates that the definition of "employee" includes government officers and employees, elected officials, and corporate officers. The statute does not purport to limit withholding to the persons listed therein.

Sullivan v. United States, 788 F.2d 813, 815 (1st Cir. 1986) (emphasis in original). Thus, the word "includes" as used in the definition of "employee" is a term of enlargement, not of limitation. See *id.*; see also *United States v. Latham*, 754 F.2d 747, 750 (7th Cir. 1985). Based on the foregoing, the fact that Petitioner did not work for the government during the years at issue is irrelevant to determining whether he had gross income.

Petitioner also relies on I.R.C. § 861 to argue that he has no income from taxable sources. However, Petitioner's reliance on I.R.C. § 861 is misplaced, which is illustrated by the decision in *Norman F. Dacey v. Commissioner*, T.C.M. 1992-187 (1992). In *Dacey*, the Court stated:

As a citizen of the United States during the years at issue, petitioner is subject to United States Federal income tax on his worldwide income. Sec. 1; *Cook v. Tait*, 265 U.S. 47 (1924); sec 1.1-1(a)(1) and (c), Income Tax Regs. It is unnecessary to determine whether that income was from sources within or without the United States since petitioner is not a nonresident alien. See sec. 861. . . .

Petitioner's royalty income received during the years at issue is includable in his gross income as a United States citizen.

Id. at 92-935.

In the present case, there is no evidence to conclude that Petitioner was a nonresident alien during the years at issue. Rather, the evidence indicates that Petitioner was a citizen of the United States during the years at issue. Therefore, I.R.C. § 861 does not apply to this case, nor does 26 CFR Sec. 1.861-8. However, I.R.C. § 61(a) does apply to this case, and provides that gross income includes compensation for services. Petitioner received compensation for services he rendered. Therefore, he received gross income.

An assessment of additional income tax is presumed correct. See *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 191 P.2d 729 (1948). Petitioner has produced insufficient evidence to prove that the Section's modified assessments are incorrect. Therefore, the Section's modified assessments must be upheld as being correct.

The failure to file when due penalty may be abated only upon a showing that the failure to timely file is due to reasonable cause and not due to wilful neglect. See A.R.S. § 42-1125.A. "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). Reasonable cause has not been established. Therefore, the imposition of the failure to file when due penalties 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 Section's modified assessments are affirmed.

DATED this 2nd day of April, 2008.

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