

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)
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DECISION OF
HEARING OFFICER
Case No. 200800093-I

A hearing was held on September 9, 2008 in the matter of the protest of [REDACTED] and [REDACTED], husband and wife (Taxpayers), to an assessment of income tax, penalty and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2003.

FINDINGS OF FACT

Taxpayers filed their 2003 Arizona state income tax return on or about July 18, 2004. Taxpayers received a refund for tax year 2003 because their withholdings of \$5,559 surpassed the amount of tax that they calculated to be due. 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)], on February 27, 2008 the Section sent Taxpayers a notice of proposed assessment of income tax for the 2003 tax year. The notice requested payment of additional tax, penalty and interest in the amount of \$3,991.52.

On March 4, 2008, Taxpayers returned the Department's Taxpayer Response Form and indicated that they disagreed with the proposed assessment and wished to file a protest. Taxpayers enclosed copies of various documents to support their protest.

After reviewing all information submitted by Taxpayers to date, the Section decided a modification of the proposed assessment was in order. The modified assessment was sent to Taxpayers on March 12, 2008. In the modified assessment, the Section increased Taxpayers' adjusted gross income by \$277 for unreported dividend income, denied a \$20,000 parent/ancestor exemption, and also denied \$810 of various credits claimed by Taxpayers. The Section increased Taxpayers' dependent deduction by \$4,600 and increased their deduction for charitable contributions by \$60. Based on these adjustments, the Section calculated an additional tax due of \$1,393.72 and \$407.43 of interest. The Section also assessed a \$250.87 penalty, pursuant to A.R.S. § 42-1125.A, for failing to file the 2003 return when it was due.

On March 19, 2008, Taxpayers timely protested the modified assessment and requested a formal hearing on the matter. Taxpayers' response to the modified assessment only protested the \$250.87 penalty for failure to file the 2003 return when due. Consequently, Taxpayers sent a check in the amount of \$1,801.15 along with their protest. The check covered the tax and interest portion of the modified assessment, but did not cover the penalty. In the correspondence attached to their protest, Taxpayers explained that they were not paying the total amount until they received a formal hearing on the matter. Regarding their objection toward the penalty, Taxpayers explained:

According to AZ 140 instruction, we would be penalized ONLY IF WE OWE tax for 2003. The fact is we did not owe [the] AZ Dept. of

Revenue money in 2003. In 2003, our state tax withheld was \$5559 (shown W-2). The tax we needed to pay in 2003 year was \$2829.72 according to the auditor. With the correction of the \$810 School credit, the total is \$3639.72 which is [s]till LESS than \$5559.

At the hearing, Mrs. [REDACTED] reiterated that she was only protesting the penalty for failure to file when due and that Taxpayers agreed with the remainder of the modified assessment. At issue is the propriety of the Section's modified assessment; more specifically the failure to file when due penalty.

CONCLUSIONS OF LAW

With respect to the failure to file when due penalty, A.R.S. § 42-1125.A provides in part as follows:

A. If a taxpayer fails to make and file a return for a tax administered pursuant to this article on or before the due date of the return or the due date as extended by the department, then, unless it is shown that the failure is due to reasonable cause and not due to wilful neglect, four and one-half per cent of the tax required to be shown on such return shall be added to the tax for each month or fraction of a month elapsing between the due date of the return and the date on which it is filed. The total penalty shall not exceed twenty-five per cent of the tax found to be remaining due. . . . For the purpose of computing the penalty imposed under this subsection, the amount required to be shown as tax on a return shall be reduced by the amount of any part of the tax which is paid on or before the beginning of such month and by the amount of any credit against the tax which may be claimed on the return. (Emphasis added.)

Taxpayers' 2003 Arizona income tax return was dated July 18, 2004. Unless an extension is granted, individual income tax returns are due on April 15th of the year following the close of the calendar year. See A.R.S. § 43-325. Taxpayers had not

requested, nor had the Department granted, an extension for the Taxpayers to file their 2003 income tax return. Therefore, the 2003 return was over three months late.

In the modified assessment, the Section assessed a late filing penalty of \$250.87. The amount of this penalty was presumably calculated by multiplying the amount due under the assessment (\$1,393.72) by 18% (4.5% x 4 months overdue).¹ However, the Section did not seem to take into account the reduction for the tax paid via withholding during the year.

A.R.S. § 42-1125.A provides that the penalty is equal to "four and one-half per cent of the tax required to be shown on such return." (Emphasis added.) According to the modified assessment in this case, the correct amount of the tax that was required to be shown on the return was \$2,829.72.

However, A.R.S. § 42-1125.A also provides that when computing the amount of the penalty, "the amount required to be shown as tax on a return shall be reduced by the amount of any part of the tax which is paid on or before the beginning of such month." (Emphasis added.) In this case, Taxpayers' employer had withheld and submitted \$5,559 in taxes on Taxpayers' behalf for tax year 2003. That amount was deemed to have been paid on or before the due date of the return. Taxpayers argue that because they did not owe the State of Arizona any taxes on the due date of the return they should not be penalized.

¹ \$1,393.72 x .18 = \$250.87.

Neither Taxpayers, nor the Section cited any Arizona case law that specifically addresses the matter at issue. The Hearing Office was also unable to find any Arizona case law on point. However, there is federal case law addressing a similar federal penalty statute.

Section 6651(a) of the Internal Revenue Code (I.R.C.) states in part as follows:

(a) Addition to the tax

In case of failure—

(1) to file any return . . . on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

26 U.S.C. § 6651(a)(1). The statute further provides that for purposes of subsection (a)(1), "the amount of tax required to be shown on the return shall be reduced by the amount of any part of the tax which is paid on or before the date prescribed for payment of the tax and by the amount of any credit against the tax which may be claimed on the return." 26 U.S.C § 6651(b)(1) (emphasis added). The language in Section 6651(a), and particularly Section 6651(b), is nearly identical to the language found in A.R.S. § 42-1125.A.

In *Harris v. Comm'r*, 51 T.C. 980 (Tax Ct. 1969), the United States Tax Court faced a situation similar to the one at issue

here. In *Harris*, the taxpayer mailed his income tax return on June 25th, computing his tax liability to be \$171.50. See *id.* at 983. Because the taxpayer's employer withheld federal income taxes of \$766.90 during the year at issue, the taxpayer's return showed a refund due of \$595.40. See *id.* The IRS issued a notice of deficiency determining that the correct amount of income tax for that year should have been \$413.20. See *id.* Therefore the notice showed a deficiency of \$241.70 (\$413.20 correct amount - \$171.50 reported on the return). See *id.* The IRS' notice of deficiency also assessed a late filing penalty pursuant to I.R.C. § 6651(a). See *id.* at 986.

In that case, the Tax Court held as follows:

Section 6651(a) imposes the addition to tax based upon a percentage of the amount of tax required to be shown on the return. Section 6651(b) directs that when computing the addition to tax, the amount of tax required to be shown on the return should be reduced by the amount of tax which had been paid before the return was originally due.

. . . Pursuant to section 6651(b), the amount of tax required to be shown on the return (\$413.20) must be reduced by the amount which had been paid before the date upon which the return was due (\$766.90), or to zero. Since the addition to tax of section 6651(a) is computed based upon the amount required to be shown (zero) no addition to tax is due.

The Commissioner's regulations concur in result with our refusal to sustain the addition to tax as determined. Section 301.6651-1(b) explains by example that withholding taxes paid during the year in issue are used to reduce the amount required to be shown on the return. Therefore, [the IRS'] determination of an addition to tax is erroneous and cannot be sustained.

Id. at 987.

Although *Harris* is a federal case, Arizona generally follows the federal interpretation of similar or identical statutory language. See *People of Faith, Inc. v. Arizona Dep't of Revenue*, 171 Ariz. 140, 154, 829 P.2d 330, 344 (App. 1992). The language of the penalty statute in A.R.S. § 42-1125.A is very similar to the federal penalty statute found in I.R.C. § 6651(a)(1) and (b)(1).

When applied to the facts in our case, the amount of tax that was required to be shown on the return (\$2,829.72) must be reduced by the amount that was paid before the due date of the return (\$5,559), or zero. Therefore, applying the computation under A.R.S. § 42-1125.A, the amount of the penalty is zero. Consequently, the Section's assessment of the \$250.87 penalty for failure to file the 2003 return when due cannot be upheld.

Taxpayers have agreed with the remaining portions of the assessment. Therefore, there is no need to address those issues.

Based on the foregoing, the Section's proposed assessment is affirmed, with the exception that the penalty for failure to file the return when due is abated.

DATED this 22nd day of September, 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