BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	**DECISION OF HEARING OFFICER**
[REDACTED]	)	
UTI #[REDACTED]	)	**Case No. 200800140-I**
	)	

A hearing was held on September 16, 2008 in the matter of the protest of [REDACTED] and [REDACTED] (Taxpayers) to an assessment of income tax and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for the tax year 2001.

FINDINGS OF FACT

Mr. [REDACTED] receives a pension from the Civil Service Retirement System (CSRS) and a military pension. The 2001 Forms 1099-R indicate that Mr. [REDACTED] is the recipient of the pension income and reports the income in his name and under his social security number only. Taxpayers timely filed a joint Arizona income tax return for 2001 and claimed two $2,500 exclusions from income relating to the CSRS pension income: one subtraction is for Mr. [REDACTED] and one subtraction is for Mrs. [REDACTED]. The Section reviewed Taxpayers' 2001 Arizona return and allowed Taxpayers only one $2,500 subtraction for 2001. The Section accordingly issued a proposed assessment for the 2001 tax year that included income tax and interest.

Taxpayers timely protested the proposed assessment and attached a copy of a 2005 letter to the Department stating the

basis of their protest. In that letter, Mr. [REDACTED] summarized their position as follows:

> **In summary, it is our position that we both have equitable interests in the CSRS. My spouse's legal interest accrued not after my death, nor even after we start[ed] receiving the annuity benefits, but as soon as we met the nine month marriage requirement (Sep 1985). At this time, and ever since, she has had a vested equitable interest in this plan every bit as valid as my own. . . .**

Because each spouse had an interest in the CSRS, Taxpayers assert that each spouse is entitled to a pension exclusion. Mr. [REDACTED]'s letter recognized that the Arizona Court of Appeals ruled that taxpayers in a similar situation were entitled to only one $2,500 deduction. *See Ariz. Dep't of Revenue v. Raby*, 204 Ariz. 509, 65 P.3d 458 (App. 2003). However, Mr. [REDACTED] asserted that the present case can be distinguished from the *Raby* case in that the present case deals with subtractions for federal retirement plans (A.R.S. § 43-1022.2(a)), while the *Raby* case dealt with subtractions for Arizona retirement plans (A.R.S. § 43-1022.2(b)).

At the hearing, Mr. [REDACTED] focused on the CSRS retirement rather than his military retirement, and clarified that his protest was based on the treatment of the CSRS retirement. At issue is the propriety of the Section's proposed assessment.

CONCLUSIONS OF LAW

A.R.S. § 43-1022 provides in part that when computing Arizona adjusted gross income, the following shall be subtracted from Arizona gross income:

> **2. Benefits, annuities and pensions in an amount totaling not more than two thousand five hundred dollars *received* from one or more of the following:**
>
> **(a) The United States government service retirement and disability fund, retired or retainer pay of the uniformed services of the United States, the United States foreign service retirement and disability system and any other retirement system or plan established by federal law. (Emphasis added.)**

The Department adopted a rule in the Arizona Administrative Code to interpret A.R.S. § 43-1022(a) and (b). The language of the rule has been in effect since 1992,[1] and has interpreted the statute as follows:

> ***An individual* is allowed to subtract up to $2,500.00 per taxable year from Arizona gross income for income *received* from sources as delineated in A.R.S. § 43-1022(2)(a) and (b).**
>
> **1. *An individual receiving* income from more than 1 such source shall only subtract a total of $2,500.00 for all such income *received* during the taxable year.**
>
> **2. The amount allowed as a subtraction is calculated *per individual*. The allowable subtraction for a married-filing-joint return when both spouses *receive* income from 1 or more such sources is determined based on the actual amount of income which is *received by each individual but not to exceed $2,500.00 per individual*.**
>
> **3. The aggregate subtraction allowed for purposes of individuals filing married-filing-separate returns shall not exceed the limitations as delineated in this rule. (Emphasis added.)**

A.A.C. R15-2C-301, as recodified June 2, 2000 (emphasis added).

---

[1] See A.A.C. R15-2-1022.01, effective July 30, 1992.

Pursuant to the above referenced statute and rule, the maximum subtraction allowable for qualified government pension income is limited to $2,500 per recipient. At issue is whether Mr. and Mrs. [REDACTED] are each considered recipients who are allowed a $2,500 subtraction (for a total of $5,000) for the payments made from Mr. [REDACTED]'s CSRS retirement annuity.

In order to determine the scope of the statute, it is necessary to determine the intent of the legislature. *See Mail Boxes, Etc. v. Indus. Comm'n of Ariz.*, 181 Ariz. 119, 121, 888 P.2d 777, 779 (1995) ("The primary rule of statutory construction is to find and give effect to legislative intent."). Where there is also an administrative rule that addresses the issue in this case, it is important to note that the rules of statutory construction apply to administrative rules as well as statutes. *See Kimble v. City of Page*, 199 Ariz. 562, 565, 20 P.3d 605, 608 (App. 2001).

When interpreting an ambiguous statute, it is important to "consider the statute as a whole and attempt to give it a fair and sensible meaning while avoiding a construction that produces an absurd result." *Raby*, 204 Ariz. at 511, 65 P.3d at 460. However, it is well settled that deductions and credits are a matter of legislative grace and not a matter of taxpayer right. As such, "tax deductions, subtractions, exemptions, and credits are to be strictly construed" against the taxpayer and in favor of the taxing authority. *Id.*; *see also Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969).

The Arizona Court of Appeals recently addressed the legislative intent of the subtraction under A.R.S. § 43-1022.2(b). *See Raby*, 204 Ariz. 509, 65 P.3d 458. In *Raby*, the taxpayers received retirement income from the Arizona State Retirement System (ASRS) resulting from Mr. Raby's retirement from state employment. *Id*. The Rabys argued that "by virtue of Arizona's community property laws" both Mr. and Mrs. Raby had equal community property interest in the retirement sums paid from ASRS. *Id*. at 511, 65 P.3d at 460. Therefore, they argued, the retirement income was "received" by each of them individually and they should each be entitled to a $2,500 subtraction under A.R.S. § 43-1022.2. *Id*.

The court of appeals agreed that "Mr. Raby's retirement benefits are a form of deferred compensation acquired during the Rabys' marriage, and that Mrs. Raby therefore has a proprietary interest in the benefits equal to that of her husband." *Id*. (citations omitted). However, the court also agreed with the Department's interpretation that the spouse "on whose account retirement payments are made" is the individual who "receives" the payments for purposes of the subtraction. *Id.* at 514, 65 P.3d at 463. Consequently, the court found that for purposes of the statute, only Mr. Raby was treated as having "received" the payment. *See id.* Therefore, the court held that the Rabys were only entitled to a single $2,500 subtraction. *Id*.

Taxpayers assert that their situation is different from *Raby* because the present case deals with subtractions for federal retirement plans (A.R.S. § 43-1022.2(a)), while the *Raby*

case dealt with subtractions for Arizona retirement plans (A.R.S. § 43-1022.2(b)). At the hearing, Mr. [REDACTED] argued that the federal property laws are different than Arizona community property laws. He emphasized that his CSRS pension was not community property (as was the case in *Raby*) because it was earned while Taxpayers were living in a non-community property state. Mr. [REDACTED] also testified that under federal law, his wife began obtaining legal interest in his CSRS retirement plan within nine (or twelve) months after their marriage. Assuming that is correct, such federal law would not give Mrs. [REDACTED] any greater proprietary interest in Mr. [REDACTED]'s pension than Arizona's community property laws would give. If the pension at issue was community property, Mrs. [REDACTED] would also have received an immediate proprietary interest (equal to that of her husband) in the portion of the pension earned during their marriage. *See Raby*, 204 Ariz. at 511, 65 P.3d at 460.

The distinction noted by Mr. [REDACTED] between the federal law and community property law does not affect the outcome in this case. Further, there is no difference in the intent of subparagraphs (a) and (b) of A.R.S. § 43-1022.2. The same $2,500 exclusion applies to both types of retirement plans. The Administrative Rule confirms this, as it applies equally to A.R.S. § 43-1022.2(a) and (b). *See* A.A.C. R15-2C-301. It would be illogical to allow two $2,500 exemptions for a married couple who receives a pension from one spouse's former federal government employment, while disallowing two $2,500 exemptions

where the pension came from state government employment. There is no basis for finding that the Arizona legislature meant for the two subparagraphs, in their current form, to apply differently in this case. Indeed, the subtraction was modified by the legislature in 1989 to apply the $2,500 subtraction equally to state and federal retirements.[2]

Testimony at the hearing established that the CSRS pension resulted from Mr. [REDACTED]'s former employment with the federal government. Consequently, for purposes of A.A.C. R15-2C-301 and A.R.S. § 43-1022.2(a), Mr. [REDACTED] is the "individual" who "received" the pension income. Hence, for the same reasons set forth in *Raby*, Taxpayers are limited to only one $2,500 subtraction for Mr. [REDACTED]'s pension income for 2001.

Although not discussed at length at the hearing, Taxpayers are not allowed an extra $2,500 subtraction for Mr. [REDACTED]'s military pension. Paragraph 1 of A.A.C. R15-2C-301 makes it clear that "[a]n individual receiving income from more than 1

---

[2] The Arizona Court of Appeals noted that when the subtraction was originally enacted in 1978, A.R.S. § 43-1022 "provided an unlimited exclusion for state and local retirement benefits, but limited a corresponding exclusion for United States Civil Service retirement annuities to $2,500.00." *Raby*, 204 Ariz. at 512, 65 P.3d at 461. However, after the United States Supreme Court (in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989)) found that a similar Michigan law "violated the doctrine of intergovernmental immunity," the "Arizona Legislature amended A.R.S. § 43-1022 to apply the $2,500.00 limit to '[b]enefits, annuities and pensions . . . received from . . . the state retirement system . . .' as well as to those from the United States Government. *Raby*, 204 Ariz. at 512, 65 P.3d at 461 (quoting A.R.S. § 43-1022(3)(a)-(b), as amended by 1989 Ariz. Sess. Laws ch. 312, § 12).

such source shall only subtract a total of $2,500.00 for all such income *received* during the taxable year."

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 proposed assessment is affirmed.

DATED this 25th 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