BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of [REDACTED] UTI # [REDACTED]	DECISION OF ACTING HEARING OFFICER Case No. 200800183-I

A hearing was held on March 31, 2009, in the matter of [REDACTED] (Petitioners) in connection with Petitioners' protest of 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 1999 and Petitioners' requests for refund of income tax and interest for tax years 1999 through 2006. The record in this matter was left open until July 6, 2009, to allow for post-hearing memoranda. Petitioners timely filed their opening post-hearing memorandum on May 18, 2009. The Section timely filed its response memorandum on June 17, 2009. Petitioners timely filed their reply memorandum on July 6, 2009. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

During the tax years at issue, Petitioner [REDACTED] was a partner with [REDACTED]("the Partnership") that maintained offices in Arizona and in other states and countries. The Partnership filed composite income tax returns on behalf of its nonresident partners in various states. Petitioners were Arizona residents during tax years 1999 through 2006, and participated in composite returns filed in other states.

Petitioners also filed individual nonresident income tax returns in several states. In Arizona, Petitioners filed individual income tax returns in which they claimed a credit for income taxes paid to another state or country pursuant to Arizona Revised Statutes ("A.R.S.") § 43-1071. With each of their returns for tax years 1999 through 2003, Petitioners submitted a schedule, issued to them by the Partnership, that lists the amounts of partnership income allocated by the Partnership to Petitioner [REDACTED] for various states and taxes paid to those states on his behalf. Other schedules list income from other countries and taxes paid to those countries. For later tax years, Petitioners submitted those schedules after the hearing.

Assessment for Tax Year 1999

In their original income tax return for tax year 1999, Petitioners claimed a credit in an amount of $[REDACTED] for taxes paid to another state or country. The Section audited Petitioners' 1999 Arizona return and reduced Petitioners' credit for taxes paid to other states by $[REDACTED] to an adjusted amount of $[REDACTED]. The adjustment was based on corrections to the method of calculating the credit. On January 15, 2003, the Section issued a proposed assessment for additional tax of $[REDACTED] plus late payment penalty and interest. Petitioners timely protested the proposed assessment. [REDACTED]

By letter of July 7, 2003, the Section abated the late payment penalty on the 1999 proposed assessment. On April 13, 2004, Petitioners filed an amended income tax return for tax

year 1999, reducing their claimed credit for taxes paid to other states to $[REDACTED], the amount calculated in the Section's proposed assessment. In the amended return, Petitioners explained that their original return used "taxable income" as the denominator in calculating the credit, whereas their amended return used "income subject to tax defined in A.A.C. R15-2C-501." With their amended return, Petitioners paid the assessed additional tax and the interest as of the time of the assessment. Petitioners also informed the Section by fax of April 14, 2004 that they had mailed an amended 1999 tax return with payment. In their fax, Petitioners did not explain whether they intended their amended return to be a withdrawal of their protest of the proposed assessment.

<u>Tax Returns Filed for Tax Years 2000 through 2006</u>

For tax year 2000, Petitioners claimed a credit for taxes paid to another state or country in an amount of $[REDACTED] in their original return and reduced that claimed amount to $[REDACTED] by amended return filed June 30, 2004.

For tax year 2001, Petitioners claimed a credit for taxes paid to another state or country in an amount of $[REDACTED] in their original return and reduced that claimed amount to $[REDACTED] by amended return filed August 14, 2004.

For tax year 2002, Petitioners claimed a credit for taxes paid to another state or country in an amount of $[REDACTED] in their original return and reduced that claimed amount to $[REDACTED] by amended return filed October 6, 2004.

Each amended return for tax years 2000, 2001, and 2002 includes the explanation that "income subject to tax" instead of "taxable income" is used in the denominator of the credit calculation. With each amended return, Petitioners paid the difference between the originally claimed credit and the reduced credit amount.

For tax year 2003, Petitioners claimed a credit for taxes paid to another state or country in an amount of $[REDACTED] in their original return and increased that claimed amount to $[REDACTED] by amended return filed January 8, 2005. In the amended return, the increase is explained to reflect a credit for foreign taxes not previously reported.

Petitioners claimed credits for taxes paid to another state or country in their original returns in amounts of $[REDACTED] for tax year 2004, $[REDACTED] for tax year 2005, and $[REDACTED] for tax year 2006.

Purported Tax Refund Claims

By letter dated March 30, 2006, representatives for Petitioners asserted an income tax refund claim on behalf of Petitioners "of all Arizona income taxes unlawfully imposed . . . as a result of the Arizona Department of Revenue's wrongful and improper interpretation . . . of A.R.S. § 43-1071(A)(3) . . ." and stated that they were making that claim for the years 1998 through 2005. The letter mentioned that the claim was based upon the Arizona Court of Appeals' decision in *Stearns v. Arizona Department of Revenue*, 212 Ariz. 333, 131 P.3d 1063, (App. 2006). The letter did not state a

claimed refund amount, but asserted that Petitioners' amended return for 1999 identified the amounts of refund claimed for that year.

On April 20, 2007, representatives for Petitioners submitted another letter containing essentially the same wording as the March 30, 2006 letter, but with respect to tax year 2006.

By letter dated August 10, 2007, representatives for Petitioners submitted a Power of Attorney, Arizona Form 285, signed by Petitioners for tax years 1998 to 2007, and requested a hearing on Petitioners' purported claims for refund for tax years "1999 to the present". The letter asserts that the Department did not respond to previous claim letters dating back "as far as April 14, 2004."

In a letter of September 28, 2007, the Section requested information from Petitioners' composite returns to make adjustments to Petitioners' 1999 tax liability. By letter of September 9, 2008, the Section repeated that request for tax years 1999 through 2005, and explained that there was no pending refund claim for 1998. The Section further explained that it was preparing to address Petitioners' claims for refund for tax years 1999 through 2005 and pointed out that its request for information was not intended to waive any defenses to the claims, including the statute of limitations.

By letter dated October 8, 2008, Petitioners informed the Section that they would not respond to the Section's requests for information and requested that the Department set a date for an administrative hearing. Petitioners also attached a copy of

a letter addressed to the Department and dated April 14, 2004, in which a refund claim "of all Arizona income taxes unlawfully imposed . . . as a result of the Arizona Department of Revenue's wrongful and improper interpretation . . . of A.R.S. § 43-1071(A)(3) . . ." is asserted for tax year 1999, referring to an amended tax return for the amount of refund claimed. With their post-hearing reply memorandum, Petitioners submitted a certified mail receipt for a mailing to the Department on April 14, 2004.

By letter dated March 4, 2009, Petitioners stated claimed refund amounts for the tax years at issue. For tax years 1999 through 2002, Petitioners listed the amounts of their credit reductions per their amended returns and asserted that those amounts were actually claimed refund amounts. The respective amounts are $[REDACTED] for 1999, $[REDACTED] for 2000, $[REDACTED] for 2001, and $[REDACTED] for 2002. Petitioners attached copies of their amended returns, including credit calculations that show the computation of the reduced credits. For tax years 2003 through 2006,[1] Petitioners submitted credit calculation sheets and stated that they were claiming refunds in the amounts of $[REDACTED] for 2003, $[REDACTED] for 2004, $[REDACTED] for 2005, and $[REDACTED] for 2006. Petitioners did not submit copies of composite returns. Instead, they resubmitted the 2000 and 2003 schedules issued to them by the

[1] Petitioners also stated a claimed refund amount for tax year 2007, which is not at issue here.

Partnership and that were included in their original tax returns for those years.

By letter dated March 24, 2009, and per the Section's request, Petitioners submitted copies of their federal Foreign Tax Credit Forms 1116 from their 2000 through 2003 federal income tax returns.

Prior to the formal hearing, the Section recalculated Petitioners' credit for taxes paid to other states or countries on the basis of the Section's interpretation of the *Stearns* decision. At the hearing, the Section explained that its revised calculation was only intended to show that Petitioners are not entitled to a refund and that the Section is not seeking to increase the 1999 assessment.

By letter of May 15, 2009, after reviewing a list of errors that the Section believed were included in Petitioners' credit claims, Petitioners revised their credit calculations. Petitioners are now claiming a credit of $[REDACTED] and a refund of $[REDACTED] for 1999, a credit of $[REDACTED] and a refund of $[REDACTED] for 2000, a credit of $[REDACTED] and a refund of $[REDACTED] for 2001, a credit of $[REDACTED] and a refund of $[REDACTED] for 2002, a credit of $[REDACTED] and a refund of $[REDACTED] for 2003, a credit of $[REDACTED] and a refund of $[REDACTED] for 2004, a credit of $[REDACTED] and a refund of $[REDACTED] for 2005, and a credit of $[REDACTED] and a refund of $[REDACTED] for 2006.

On May 26, 2009, Petitioners provided additional income schedules issued to them by the Partnership and their individual nonresident income tax returns filed in several other states.

In response to Petitioners' additional information provided after the formal hearing, the Section again recalculated the credit for taxes paid to New York in 1999, 2000, and 2001, and for taxes paid to Minnesota in 2001. Compared to the Section's earlier calculations, the credit amounts for taxes paid to New York were reduced while the credit amount for taxes paid to Minnesota remained unchanged.

The Parties' Positions

Petitioners argue that their credit and refund claims were timely filed by Petitioners' letters dated April 14, 2004, March 30, 2006, April 20, 2007, and March 4, 2009.

Petitioners disagree with the Section's calculation of the credit for taxes paid to other states or countries and argue that the Section used an incorrect methodology. Petitioners argue that their own credit calculation in their May 15, 2009 revised refund claims is consistent with the decision in *Stearns.* In the fraction, which is multiplied with a taxpayer's Arizona tax to arrive at the maximum allowable credit amount for each state pursuant to A.R.S. § 43-1071(A)(3), Petitioners use a numerator in the amount of their gross income in the other state [REDACTED]. Petitioners argue that the numerator was not raised as an issue in *Stearns*, and that the court in *Stearns* did not address the numerator to calculate the credit.

Alternatively, Petitioners argue that the mentioning of the credit fraction's numerator in *Stearns* indicates that the court was referring to the net income in the other state or country. Petitioners argue that for purposes of the numerator, the income taxed in the other state should not be reduced by allocating a pro-rata share of Arizona deductions to that income. Petitioners provided an alternative calculation of the credit for the years at issue that uses a numerator in the amount of the portion of the out-of-state income that is taxable in the other states.

[REDACTED]

Petitioners further argue that A.R.S. § 43-1071(A)(2), concerning states that allow a credit for Arizona taxes, does not prevent them from claiming a credit for taxes paid to Indiana and Virginia. Petitioners state that taxpayers who participate in a composite return in either Indiana or Virginia are not allowed a credit for Arizona taxes. Petitioners argue that A.R.S. § 43-1071(A)(2) does therefore not bar them from claiming the credit for taxes paid to Indiana and Virginia on their Arizona tax returns.

The Section argues that Petitioners' credit and refund claims for tax years 2000, 2001, 2002, and 2003 are untimely pursuant to A.R.S. §§ 42-1104, 42-1106 because Petitioners did not file anything purporting to be a refund claim for those years until March 30, 2006, and because Petitioners did not file a claim setting forth the amount of the refund requested until 2009. The Section states that it has no record of the April 14,

2004 letter referencing tax year 1999, and that this letter cannot suffice as a refund claim for any other year.

Concerning the calculation of the credit, the Section argues that pursuant to A.R.S. § 43-1071(A)(3), the numerator of the fraction used to calculate the credit is the income subject to tax in the other state or country and also taxable under A.R.S. Title 43 and that, accordingly, the income reported to the other state must be adjusted to determine the portion of that income that is taxable under Arizona law. The Section asserts that the *Stearns* decision set forth the legal standard for the credit fraction's numerator being the portion of the out-of-state income that is taxable under Arizona law. The Section further argues that the Arizona exemptions and deductions are not specifically related to only the Arizona income and must be applied on a pro-rata basis to determine what portion of the out-of-state income is taxable under Arizona law. If the out-of-state income is not reduced on such a pro-rata basis, the Section argues, the amount of the out-of-state income taxable in both Arizona and the other state could exceed the Arizona taxable income, which would be absurd because the numerator in the credit fraction should never exceed the denominator. The Section argues that its method of pro-rating the Arizona exemptions and deductions is consistent with the manner in which the Internal Revenue Service calculates the federal foreign tax credit.

[REDACTED]

The Section argues that Petitioners are not entitled to any credits for taxes paid to Indiana and Virginia because A.R.S. § 43-1071(A)(2) does not allow the credit for taxes paid to a state where a credit is available to Arizona residents for tax paid to Arizona, and that Petitioners chose to forego that credit in Indiana and Virginia when they elected to participate in the filing of a composite return.

At issue are the timeliness of Petitioners' credit and refund claims and the calculation of the credit provided in A.R.S. § 43-1071 for taxes paid in other states or countries.

CONCLUSIONS OF LAW

Timeliness of Credit and Refund Claims

A taxpayer has four years from the date a tax return is filed, or is required to be filed, whichever is later, in which to file a credit or refund claim. A.R.S. §§ 42-1104, 42-1106. A.R.S. § 42-1106(D) provides that the failure to begin an action for a credit or refund within the time specified in A.R.S. § 42-1106 is a bar against the recovery of taxes by the taxpayer. Pursuant to A.R.S. § 42-1118(E), a refund claim must provide the amount of refund requested and the specific grounds on which the claim is founded.

For tax year 1999, Petitioners timely protested the Section's assessment, then filed an amended return in which they calculated the credit as the Section did in the assessment, and paid the assessment. Although the filing of the amended return raises a question as to whether Petitioners intended that return

to serve as a withdrawal of their protest, Petitioners did not specifically indicate that intention in their amended return or in their written communication by fax of April 14, 2004 to the Section. Interpreting Petitioners' payment of the assessment merely as a payment under protest, as the Section has done, is therefore appropriate. Under A.R.S. § 42-1118(I), Petitioners' protest of the assessment is therefore treated as a claim for refund in the amount of the assessed additional tax of $[REDACTED]. In their May 15, 2009 letter, Petitioners reduced their refund claim to $[REDACTED].

The Section argues that Petitioners' claims for tax years 2000 through 2003 are untimely. Petitioners did not address the timeliness of their claim for tax year 2000 in their post-hearing memoranda, arguing only that their claims for tax years 2001 through 2003 are timely. The four-year limitations period for tax year 2000 expired in 2005. Petitioners' April 14, 2004 letter did not mention any claim for tax year 2000, and the March 30, 2006 letter was outside the limitations period for the 2000 tax year. There is no timely claim for tax year 2000.

For tax years 2001 through 2003, Petitioners argue that they first submitted their claims by letter of March 30, 2006, and that they reminded the Department of their claims in letters dated April 20, 2007 and March 4, 2009. In their letters of March 30, 2006 and April 20, 2007, Petitioners never stated any specific amount of tax they wished to have refunded, but vaguely declared that they were requesting refunds "of all Arizona income taxes unlawfully imposed . . . as a result of the Arizona

Department of Revenue's wrongful and improper interpretation . . . of A.R.S. § 43-1071(A)(3) . . . ." The reference in the letters to claims based upon the Arizona Court of Appeals' decision in *Stearns* does not indicate an amount of refund requested or suggest specific changes to Petitioners' tax credits. Petitioners argue that the required information was incorporated in the March 30, 2006 letter by reference to their 1999 Arizona Form 140X. However, that amended return for tax year 1999 did not identify any amounts of refunds claimed, as it showed a reduced credit, resulting in an amount of tax owed. That amended return for 1999 made the same changes to Petitioners' credit that the Section had made in the assessment. Any conclusion to be drawn from that amended return would be that Petitioners agreed with the Section's credit calculation. The first statement of Petitioners' specific refund claims for tax years 2001 through 2003 is therefore found in their March 4, 2009 letter. The four-year limitations period for 2001, 2002, and 2003 expired in 2006, 2007, and 2008 respectively, and therefore prior to the March 4, 2009 letter.

Petitioners' claims for tax years 2000, 2001, 2002, and 2003 are untimely and thus barred under A.R.S. § 42-1106(D). Petitioners' increase of their untimely March 4, 2009 claims for tax years 2000 and 2001 by letter of May 15, 2009 is likewise untimely. For tax year 2004, Petitioners' March 4, 2009 letter resulted in a timely refund claim, which Petitioners reduced to $[REDACTED] by letter of May 15, 2009. The March 4, 2009 and

May 15, 2009 letters are also timely for tax years 2005 and 2006.

Calculation of the Credit provided in A.R.S. § 43-1071

Petitioners are seeking a tax credit in an amount larger than the Section allowed in its assessment for 1999 and in its revised calculation of the credit. An assessment of additional income tax is presumed correct. *See Arizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948). Tax credits are obtained by legislative grace and not by right. *DaimlerChrysler Servs. N. Am., L.L.C. v. Ariz. Dep't of Revenue*, 210 Ariz. 297, 304, 110 P.3d 1031, 1038 (App. 2005). Tax statutes are construed strictly against such credits. *Ariz. Dep't of Revenue v. Raby*, 204 Ariz. 509, 511, 65 P.3d 458, 460 (App. 2003).

The resolution of this matter turns on the interpretation of A.R.S. § 43-1071, which allows Arizona residents to claim a credit for net income taxes imposed by and paid to another state or country. A.R.S. § 43-1071(A)(3), as phrased prior to the 2008 amendment by H.B. 2589, imposes the following limitation on the credit:

> The credit shall not exceed the proportion of the tax payable under this chapter as the income subject to tax in the other state or country and also taxable under this title bears to the taxpayer's entire income upon which the tax is imposed by this chapter.

A.R.S. § 43-1071(A)(3)[2]. Under this limitation, the ratio between the maximum credit amount and "the tax payable under this chapter" is the same as the ratio between "the income subject to tax in the other state or country and also taxable under this title" and "the taxpayer's entire income on which the tax is imposed by this chapter." Expressed as a formula, A.R.S. § 43-1071(A)(3) limits the credit as follows:

$$\text{Maximum Credit} = \frac{\text{Income Subject to Tax in Other State/Country \& Taxable under Title 43}}{\text{Entire Income on Which Arizona Tax Is Imposed}} \times \text{Arizona Tax Liability Before Credit}$$

The parties disagree over the computation of the numerator in the formula's fraction. Petitioners argue that the numerator should be the gross income in the other state or, alternatively, that it should be based upon the taxable income as determined by the other state, without applying pro-rata Arizona deductions. The Section takes the position that Arizona exemptions and deductions must be applied on a pro-rata basis to the out-of-state income, and that only an amount that is the smaller of that result or the taxable income as determined by the other state forms the numerator. At issue is therefore the meaning of the phrase that forms the numerator in the formula's fraction, "the income subject to tax in the other state or country and

---

[2] For taxable years beginning from and after December 31, 2007, A.R.S. § 43-1071(A)(3) was amended by Laws 2008, Ch 220 to provide: "The credit shall not exceed the proportion of the tax payable under this chapter as the income subject to tax in the other state or country and also taxable under this title bears to the taxpayer's entire income on which the tax is imposed by this chapter." (Emphasis added.)

also taxable under this title." That phrase contains the twofold requirement, that the income that forms the numerator must be subject to tax in the other state or country, and that the income must be taxable under A.R.S. Title 43. An image of two overlapping circles could illustrate this twofold requirement: If one circle includes the income subject to tax in the other state or country, and the other circle includes the other state's income that is taxable in Arizona, then only the overlapping portion of the circles would include the income in the numerator. A.R.S. § 43-1001(11) specifically defines "taxable income" of Arizona residents to mean Arizona adjusted gross income less the exemptions and deductions allowed in A.R.S. § 43-1041 et seq. Statutory interpretation must give effect to each word, phrase, and clause of the statute. *Ariz. Dep't of Revenue v. Superior Court (ASARCO Inc.)*, 189 Ariz. 49, 52, 938 P.2d 98, 101 (App. 1997). The inclusion of the term "taxable" in the phrase describing the numerator of the credit fraction in A.R.S. § 43-1071(A)(3) cannot be ignored. Reading the term "taxable under this title" in A.R.S. § 43-1071(A)(3) consistent with the definition of "taxable income" in A.R.S. § 43-1001(11) supports the reduction of the out-of-state income by Arizona exemptions and deductions to determine the income in the illustration's second circle and thus the credit fraction's numerator.

Both parties cite the Arizona Court of Appeals' decision in *Stearns*. There, the issue was the computation of the credit fraction's denominator. Petitioners point out that the *Stearns*

court used an example to demonstrate the different computation methods that were at issue there, and Petitioners argue that the court's use of that example supports their position here. The *Stearns* court explained:

> A decrease in the denominator results in an increased credit and vice-versa. The parties' calculation of the tax credit for the New Mexico taxes illustrates the effect of the different interpretations. The taxpayers reported $857 in taxable income on a composite nonresident income tax return filed with New Mexico. . . . Because the only amount provided to ADOR was $857, the income subject to both New Mexico and Arizona tax was $857.

Stearns, 212 Ariz. at 334, 335, 131 P.3d at 1064, 1065. The court then compared the parties' credit calculations, with both parties in *Stearns* using the amount of $857 as the credit fraction's numerator. Because the *Stearns* court did not mention a pro-rata application of Arizona exemptions and deductions to that amount of $857, Petitioners argue the *Stearns* decision supports their position that such a pro-rata application is unnecessary. However, the issue in *Stearns* was the credit fraction's denominator and whether that denominator should be calculated based on adjusted gross income or taxable income. The *Stearns* court assumed that the fraction's numerator was a taxable income amount and used that as a basis for its further reasoning, stating:

> Our determination that a resident taxpayer's "taxable income" forms the denominator of the tax credit fraction is also supported by the structure of § 43-1071(A), which is

> designed to provide residents "a credit against the taxes imposed by this chapter for *net income* taxes imposed by and paid another state or country on income taxable under this chapter . . . ." (Emphasis added.) Thus, the numerator of the fraction, which consists of "income subject to tax" in both the other state and Arizona, is equivalent to that portion of the out-of-state income that is taxable in both states, resulting in an "apple-to-apple" comparison, thereby preventing either a disproportionately high or low credit.

Stearns, 212 Ariz. at 335, 336, 131 P.3d at 1065, 1066. The court, there, clearly assumed that the portion of the out-of-state income that is "taxable in both states" - taxable income in the other state and also taxable income in Arizona - forms the numerator of the fraction. Based on that assumption, and without addressing whether the calculations presented by the parties in the New Mexico example were consistent with that assumption, the court concluded that the denominator also had to be taxable income instead of adjusted gross income to ensure an "apple-to-apple" comparison. The *Stearns* decision therefore not only supports applying Arizona exemptions and deductions to the out-of-state income for purposes of calculating the credit fraction's numerator, it actually results in that method being the only method for calculating the numerator that is consistent with *Stearns*.

[REDACTED]

The credit limitation in A.R.S. § 43-1071(A)(3) ensures that the credit for taxes paid to another state or country is not larger than the Arizona tax that relates to the income from

the other state or country. Without that limitation, a taxpayer could benefit from the credit beyond the proportion of his or her out-of-state income, resulting in tax credits larger than the Arizona tax imposed on that income. The credit limitation in A.R.S. § 43-1071(A)(3) therefore asks how much of a taxpayer's entire income taxable in Arizona is also subject to tax in the other state. That proportion indicates how much of the Arizona tax relates to the out-of-state income. The credit cannot exceed that amount of Arizona tax. Only when both the numerator and the denominator of the credit fraction include comparable income – the "apple-to-apple" comparison as referenced by the *Stearns* court - does the result of the credit formula reflect the amount of Arizona tax actually imposed on the out-of-state income. The process of determining the numerator must therefore include a pro-rata application of Arizona exemptions and deductions to the income from the other state or country for purposes of arriving at the Arizona taxable income from that state or country. That amount is then compared to the amount of income actually taxed by the other state or country, which may be an amount after taking deductions allowed in the other state. Only the amount that is the smaller of the taxable income as determined by the other state, or the Arizona taxable income from that state, forms the credit fraction's numerator.

Petitioners have not provided the composite returns that the Partnership filed in the other states or countries. The schedules of income that Petitioners submitted on May 26, 2009

appear to list Petitioners' "net taxable income" in the other states for some periods, in addition to the amounts of partnership income reported and the tax paid in the other states and countries on behalf of Petitioners. Petitioners submitted extensive documentation and research to demonstrate which states allow taxpayers who participate in composite returns to take deductions or exemptions and which states do not. However, even if Petitioners' reported income in another state were also their taxable income in that state, due to the lack of any allowable deductions or exemptions in that state, that would not increase Petitioners' credits as compared to the Section's revised calculations. The credit fraction's numerator is the smaller of the taxable income in the other state or country or the Arizona taxable income from that state or country. The Section's revised calculations properly use the Arizona taxable income from the other state in the numerator where only that amount was known to the Section. Identifying the taxable income under the laws of the other state can only decrease that numerator and thus result in a lower credit than calculated by the Section, but it cannot increase the numerator to raise the credit.

Finally, Petitioners argue that they should be entitled to credit amounts that they claimed for taxes paid to Indiana in 1999, 2000, 2002, and 2003, and to Virginia in 1999 and 2000. The Section argues that A.R.S. § 43-1071(A)(2) does not allow a credit for those taxes because Indiana and Virginia allow Arizona residents a credit for taxes paid to Arizona. Petitioners do not dispute that Indiana and Virginia allow such

a credit on individual nonresident income tax returns, but argue that taxpayers who participate in composite returns in those states cannot claim the credit there and should therefore be able to claim the Arizona credit for taxes paid in other states. A.R.S. § 43-1071(A)(2) provides:

> The credit shall not be allowed if the other state or country allows residents of this state a credit against the taxes imposed by that state or country for taxes paid or payable under this chapter.

The plain language of the statute requires only that a credit be available to Arizona residents under the laws of the nonresident state. Petitioners could have filed individual nonresident income tax returns in Indiana and Virginia for the years at issue to claim a credit for Arizona tax, as they did for later tax years. Instead, Petitioners elected to participate in the filing of a composite return in Indiana and Virginia and thus chose not to avail themselves of the credit afforded to Arizona residents in those states. Under A.R.S. § 43-1071(A)(2), the Section properly disallowed the credit claimed by Petitioners against their Arizona income tax for tax paid to Indiana and Virginia.

Petitioners have not demonstrated that they should be entitled to the claimed refunds. Based on the foregoing, Petitioners' protest is denied.

DATED this 4th day of September, 2009.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

Petra Sabori
Acting Hearing Officer

Original of the foregoing mailed to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

Copies of the foregoing delivered to:

Kimberly Cygan
Arizona Attorney General's Office
1275 W. Washington Street
Phoenix, AZ 85007

Arizona Department of Revenue
Individual Income Tax Audit Section