

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)	DECISION OF
[REDACTED])	HEARING OFFICER
UTI # [REDACTED])	Case No. 201000058-I
_____)	

A hearing was held on May 18, 2010 in the matter of the protest of [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 tax year 2004. At the hearing it was agreed that the matter be returned to informal status to allow Taxpayers time to provide additional documentation.

The Hearing Officer issued an order dated May 19, 2010 establishing a schedule for the submission of documentation and response by the Section and Taxpayers. Based on additional information submitted by Taxpayers, the Section issued a modified proposed assessment dated August 25, 2010. Taxpayers disagreed with the Section's modified proposed assessment, and the parties requested that this matter be reset for a hearing and a second hearing was held August 11, 2011. This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayers filed an Arizona resident state income tax return for tax year 2004.
2. Based on information received from the Internal Revenue Service (IRS), the Section noticed that the amount of federal adjusted gross income (FAGI) Taxpayers reported to the IRS was different from what was reported to Arizona.
3. The Section reviewed Taxpayers' 2004 return and issued a proposed deficiency assessment dated February 25, 2009 increasing Taxpayers' FAGI by \$[REDACTED], to the amount that had been reported to the IRS. The proposed

assessment also allowed Taxpayers dependent deductions in the amount of \$6,900 and an additional personal exemption of \$2,100; included in Taxpayers' income a \$[REDACTED] state income tax refund and \$[REDACTED] of annuity/pension income; and disallowed Taxpayers' Schedule A medical expenses of \$[REDACTED], miscellaneous itemized deductions of \$[REDACTED] and a state and local tax deduction of \$[REDACTED].

4. The proposed assessment calculated interest at the statutory rate. No penalties were assessed.
5. Taxpayers timely protested the assessment stating that the wage income not reported to Arizona was earned in [REDACTED].
6. Taxpayers did not protest the other adjustments included in the proposed assessment.
7. At the hearing held May 18, 2010 Taxpayers testified that Taxpayer [REDACTED] was an Arizona resident during tax year 2004 but was an active member of the military stationed at [REDACTED] in the state of [REDACTED].
8. Taxpayer [REDACTED] was a resident of the State of [REDACTED] and did not become an Arizona resident until July 15, 2004.
9. The income not reported to Arizona was earned by [REDACTED] in [REDACTED] before she became an Arizona resident.
10. [REDACTED] filed a part-year state income tax return with the state of [REDACTED] for tax year 2004.
11. Taxpayers received a refund of all [REDACTED] income taxes that were withheld from [REDACTED]'s wages.
12. The Section's proposed assessment included all of Taxpayer [REDACTED]'s income earned in [REDACTED] before July 15, 2004.

13. At the hearing the Section's representative testified that if [REDACTED] were a [REDACTED] resident, a modification to the proposed assessment would be in order.
14. The Section's representative testified further that the Section has a procedure for separating income so if [REDACTED] were a [REDACTED] resident until July 15, 2004, the difference in the assessment relating to FAGI would be equal to one-half of the [REDACTED] income.
15. After the May 18, 2010 hearing the matter was returned to informal status to allow Taxpayers to submit additional information and for the Section to review any information submitted.
16. Taxpayers timely submitted additional documentation.
17. Based on the additional documentation the Section accepted that [REDACTED] was a part-year Arizona resident during tax year 2004 and issued a modified proposed assessment dated August 25, 2010.
18. The modified proposed assessment included as Arizona income [REDACTED]'s wages of \$[REDACTED], [REDACTED]'s Arizona source income of \$[REDACTED], one-half of [REDACTED]'s [REDACTED] wages of \$[REDACTED], tax refunds of \$[REDACTED], [REDACTED] withdrawal of \$[REDACTED], capital gains of \$[REDACTED] and interest of \$[REDACTED] and allowed an adjustment for moving expenses of (\$[REDACTED]).
19. The modified proposed assessment pro-rated the personal exemptions and dependent deductions by 71.7%, the ratio of Arizona gross income to gross income from everywhere.
20. The modified proposed assessment also allowed additional itemized deductions that were documented. The modified proposed assessment continued to disallow deductions for medical expenses and employee business expenses in the total amount of \$[REDACTED].

21. The modified proposed assessment decreased the adjustments to income from \$[REDACTED] to \$[REDACTED].
22. Taxpayers disagreed with the Section's modified proposed assessment.
23. This matter was reset for hearing at the parties' request.
24. A second hearing was held on August 11, 2011.
25. At the second hearing Taxpayers questioned the Section's calculation of income subject to tax by Arizona. Taxpayers believe that all of [REDACTED]'s [REDACTED] source wages should be excluded from the assessment.
26. It was the Section's position at the hearing that because both Arizona and [REDACTED] are community property states, one-half of [REDACTED]'s [REDACTED] income was subject to Arizona income tax.
27. Taxpayers did not submit any additional documentation substantiating the deductions that were disallowed in the modified proposed assessment.

CONCLUSIONS OF LAW

1. Arizona law requires that taxpayers *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." Arizona Revised Statutes (A.R.S.) § 42-1105(D).
2. The burden is on the taxpayer to show he is entitled to a deduction or exemption from tax. See *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969).
3. Taxpayers have not produced documentation to support the allowance by the Section of their itemized deductions for medical expenses and employee business expenses.
4. Taxpayers have not overcome the presumption of correctness regarding the disallowance of itemized deductions in the amount of \$[REDACTED].

5. The only contested issue remaining in this case is the correct calculation of Taxpayers' Arizona income given that one of the Taxpayers was not a resident of Arizona for a part of the tax year.
6. A full-year Arizona resident spouse and a part-year Arizona resident spouse may file a joint Arizona income tax return. Arizona Individual Income Tax Ruling (ITR) 95-2.
7. A resident of Arizona is subject to income tax on all of his taxable income wherever derived. A.R.S. § 43-102(A)(4).
8. For periods after July 15, 2004, Taxpayers were subject to tax on all of their income wherever derived.
9. The Section properly included all income earned by Taxpayers after July 15, 2004.
10. For periods before July 15, 2004, one spouse was an Arizona resident and one spouse was a non-resident of Arizona.
11. A non-resident of this state is only subject to tax on taxable income derived from sources within Arizona. A.R.S. § 43-102(A)(5).
12. When a full-year resident and a part-year resident file a joint Arizona income tax return, the full-year resident individual must report all income from all sources and the part-year resident must report all income earned while an Arizona resident plus any income derived from Arizona sources while an Arizona nonresident. ITR 95-2.
13. The nonresident spouse of an Arizona resident is required to report to Arizona one-half of the community income derived from Arizona sources plus all separate income from Arizona sources. ITR 93-20.
14. Wages earned during marriage is considered to be community property. Therefore, the earnings of a nonresident spouse who resides in a community

- property state would be included in the total community income, one-half of which is reportable by the Arizona resident. ITR 93-20.
15. The nonresident spouse of an Arizona resident is required to report to Arizona one-half of the community income derived from Arizona sources plus all separate income from Arizona sources. ITR 93-20.
 16. A servicemember does not lose or acquire a residence or domicile for tax purposes with respect to the income of the servicemember by reason of being absent or present in any tax jurisdiction of the United States solely in compliance with military orders. 50 App. U.S.C.A. § 571(a).
 17. Compensation of a servicemember for military service shall not be deemed to be income for services performed or from sources within a tax jurisdiction of the United States if the servicemember is not a resident or domiciliary of the jurisdiction in which the servicemember is serving in compliance with military orders. 50 App. U.S.C.A. § 571(b).
 18. [REDACTED] was an Arizona resident during tax year 2004.
 19. [REDACTED]'s wages were not derived from [REDACTED] sources but constituted Arizona source income. 50 App. U.S.C.A. § 571(b).
 20. On Taxpayers' joint income tax return to Arizona, they were required to report all of [REDACTED]'s wages (one-half reported by [REDACTED] and one-half reported by [REDACTED]) and one-half of [REDACTED]'s wages (reported by [REDACTED] as his share of the community income).
 21. The exemptions must be apportioned as if both the full-year resident spouse and the part-year resident spouse were part-year residents. ITR 95-2.
 22. The Section properly calculated Taxpayers' income for tax year 2004 based on the Arizona Individual Income Tax Rulings and 50 App. U.S.C.A. § 571.

23. 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.
24. The Section’s modified proposed assessment dated August 25, 2010 was proper.

DISCUSSION

Taxpayers filed a joint Arizona resident individual income tax return for tax year 2004. Based on information received from the IRS, the Section noticed that the amount of FAGI Taxpayers reported to the IRS was different from what was reported to Arizona. The Section reviewed Taxpayers’ return and found that Taxpayer’s reported all of [REDACTED]’s wages and [REDACTED]’s wages earned in Arizona but none of [REDACTED]’s wages earned in [REDACTED].

The Section issued a proposed assessment increasing Taxpayers’ income to the amount that was reported to the IRS. The proposed assessment also allowed Taxpayers dependent deductions in the amount of \$6,900 and an additional personal exemption of \$2,100; included in Taxpayers’ income a \$[REDACTED] state income tax refund and \$[REDACTED] of annuity/pension income; and disallowed Taxpayers’ Schedule A medical expenses of \$[REDACTED], miscellaneous itemized deductions of \$[REDACTED] and a state and local tax deduction of \$[REDACTED]. Taxpayers protested the proposed assessment and a hearing was held.

At the hearing Taxpayers argued that in 2004 [REDACTED] was in the military stationed in [REDACTED]. While [REDACTED] was an Arizona resident, [REDACTED] was a [REDACTED] resident until she moved to Arizona in July of 2004. Taxpayers argued that wages [REDACTED] earned while in [REDACTED] were not taxable by Arizona. After the hearing Taxpayers presented additional information regarding [REDACTED]’s [REDACTED] residency before July of 2004 and substantiation for

some of the itemized deductions that had been disallowed. Based on this additional information the Section agreed that [REDACTED] was a part-year Arizona resident during 2004 and prepared a modified proposed assessment.

The modified proposed assessment allowed additional deductions that were verified and included as Arizona income [REDACTED]'s income, [REDACTED]'s Arizona income and one-half of [REDACTED]'s [REDACTED] income. Taxpayers continued to protest the inclusion in Arizona income one-half of [REDACTED]'s [REDACTED] income. Taxpayers did not protest the other adjustments made in the modified proposed assessment. The only issue left to be decided is whether the Section correctly calculated Taxpayers' Arizona income for tax year 2004.

The Arizona Department of Revenue has issued Individual Income Tax Rulings addressing the filing of tax returns and reporting income to Arizona in situations where one spouse is an Arizona resident and the other spouse is a non-resident or part-year resident. For periods before July 15, 2004, under the rulings and 50 App. U.S.C.A. § 571(b), [REDACTED], as an Arizona resident, was required to include one-half of his wage income and one-half of [REDACTED]'s wages as his share of the community income. [REDACTED] was required to include as Arizona income one-half of [REDACTED]'s wages as her share of the Arizona source community income. That is how the modified proposed assessment calculated Taxpayers' Arizona income subject to tax.

The proposed assessment also included interest. 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.

Based on the foregoing, the Section's modified proposed assessment dated August 25, 2010 is affirmed.

DATED this 29th day of September, 2011.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[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