

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	DECISION OF
[REDACTED]	)	HEARING OFFICER
UTI # [REDACTED]	)	Case No. 201200214-I
_____	)	

This matter is between [REDACTED] and [REDACTED] (Taxpayers) and the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department). At issue is the propriety of the Section's proposed assessment of tax and interest for tax year 2006. Taxpayers requested that the matter be resolved through the submission of written memoranda.

Taxpayers and the Section have submitted their respective memoranda. This matter is ready for ruling.

FINDINGS OF FACT

1. Taxpayers filed a joint Arizona resident state income tax return (Form 140) for tax year 2006.
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 inquired regarding the difference and Taxpayers responded that the difference was due to Taxpayers not including in Arizona income wages earned by Taxpayer [REDACTED] in [REDACTED] during the second half of 2006.
4. The Section issued a proposed assessment dated March 16, 2011 increasing Taxpayers' FAGI by \$[REDACTED], to the amount that had been reported to the IRS. The assessment included additional tax of \$[REDACTED] and \$[REDACTED] interest.

5. The proposed assessment calculated interest at the statutory rate. No penalties were assessed.
6. Taxpayers timely protested the assessment stating that the income not reported to Arizona was earned in [REDACTED] by [REDACTED] who became a [REDACTED] resident and abandoned Arizona residency effective September 1, 2006.
7. Taxpayers submitted an amended return that recalculated their Arizona income tax liability and included payment of \$[REDACTED] representing \$[REDACTED] tax and estimated interest.
8. Taxpayers' amended return excluded from Arizona income all of the wages (\$[REDACTED]) earned by [REDACTED] in [REDACTED].
9. Based on additional information the Section issued two modified proposed assessments dated March 7, 2012 and August 1, 2012 that took into consideration [REDACTED] [REDACTED] residency for part of tax year 2006.
10. The August 1, 2012 modified proposed assessment increased Taxpayers' FAGI by \$[REDACTED] (one-half of [REDACTED] [REDACTED] income of \$[REDACTED]), prorated Taxpayers' dependent deduction and personal exemption by the ratio of Arizona gross income to gross income from everywhere, prorated Taxpayers' interest income deduction taxable to Arizona and allowed a credit for taxes paid to [REDACTED]. The modified proposed assessment included additional tax of \$[REDACTED] and \$[REDACTED] interest.
11. Taxpayers continued to protest the modified proposed assessment.
12. Taxpayers contend that all of [REDACTED] [REDACTED] source wages should be excluded from the assessment.
13. It is the Section's position that because both Arizona and [REDACTED] are community property states, one-half of [REDACTED] [REDACTED] income was subject to Arizona income tax.

## CONCLUSIONS OF LAW

1. The only contested issue is the correct calculation of Taxpayers' Arizona income given that one of the Taxpayers was a part-year Arizona resident in 2006.
2. Both Arizona and [REDACTED] are community property states. Arizona Revised Statutes (A.R.S.) § 25-211; [REDACTED] Code § [REDACTED].
3. 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.
4. When a full-year Arizona resident and a part-year Arizona resident file a joint Arizona income tax return, they may not file using Arizona Form 140 but are required to use part-year resident Form 140PY.
5. A resident of Arizona is subject to income tax on all of his taxable income wherever derived. A.R.S. § 43-102(A)(4).
6. For periods before September 1, 2006, Taxpayers were subject to tax on all of their income wherever derived.
7. The Section properly included all income earned by Taxpayers before September 1, 2006.
8. For periods after August 31, 2006, one spouse was an Arizona resident and one spouse was a nonresident of Arizona.
9. A nonresident of this state is only subject to tax on taxable income derived from sources within Arizona. A.R.S. § 43-102(A)(5).
10. 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, p.2.

11. 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.
12. Wages earned during marriage is considered to be community property. Therefore, the earnings of a nonresident spouse who resides in a community property state are included in the total community income, one-half of which is reportable by the Arizona resident. ITR 93-20, p.1-2.
13. [REDACTED] was an Arizona resident during tax year 2006 and [REDACTED] was an Arizona resident until September 1, 2006.
14. [REDACTED] wages earned during 2006 constituted Arizona source income and [REDACTED] wages earned before September 1, 2006 constituted Arizona source income.
15. [REDACTED] wages earned after August 31, 2006 was [REDACTED] source income and community property.
16. Taxpayers were required to report on their joint income tax return to Arizona:
  - a. all of [REDACTED] wages for 2006 (one-half reported by [REDACTED] and one-half reported by [REDACTED]),
  - b. all of [REDACTED] wages earned before September 1, 2006 (one-half reported by [REDACTED] and one-half reported by [REDACTED]), and
  - c. one-half of [REDACTED] wages earned after August 31, 2006 (reported by [REDACTED] as his share of the community income).
17. 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, p.2.
18. The Section properly calculated Taxpayers' income for tax year 2006 consistent with the Arizona Individual Income Tax Rulings.

19. 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.
20. The Section’s modified proposed assessment dated August 1, 2012 was proper.

#### DISCUSSION

Taxpayers filed a joint Arizona resident individual income tax return for tax year 2006. Based on information received from the IRS, the Section noticed that the amount of FGI Taxpayers reported to the IRS was different from what was reported to Arizona. Taxpayers reported all of [REDACTED] wages and [REDACTED] wages earned in Arizona but none of [REDACTED] wages earned in [REDACTED].

The Section issued a proposed assessment increasing Taxpayers’ income to the amount that was reported to the IRS. Taxpayers protested the proposed assessment and provided additional information that showed that [REDACTED] had become a [REDACTED] resident on September 1, 2006. Taxpayers argued that wages [REDACTED] earned while in [REDACTED] were not taxable by Arizona. Based on the additional information, the Section agreed that [REDACTED] was a part-year Arizona resident during 2006 and prepared a modified proposed assessment.

The modified proposed assessment included as Arizona income [REDACTED] income, [REDACTED] Arizona income and one-half of [REDACTED] [REDACTED] income. Taxpayers continued to protest the inclusion of one-half of [REDACTED] [REDACTED] income in Arizona income. The question is whether the Section correctly calculated Taxpayers’ Arizona income for tax year 2006.

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 nonresident or part-year resident. Under the rulings, an Arizona resident is required to include in Arizona income one-half of all community property income, including income earned in another state. The nonresident

spouse is required to include in Arizona income one-half of community property income earned in Arizona. That is how the modified proposed assessment calculated Taxpayers' Arizona income subject to tax for 2006.

Taxpayers contend that ITR 93-20 only applies to married Taxpayers filing separate returns and is therefore not applicable to them because they filed a joint return. ITR 95-2 does not state that community property laws apply and does not address how to determine income to be reported to Arizona. ITR 95-2 simply allows resident and part-year resident married couples to file a joint return.

While ITR 93-20 is drafted in the context of filing separate returns, the ruling does detail the manner of determining income to be reported to Arizona. Whether a married couple files separate returns or a joint return, they are required to report to Arizona income taxable by Arizona. A.R.S. §§ 43-102(A) and 25-211 apply irrespective of the method of filing. Therefore the method of determining income taxable by Arizona prescribed by ITR 93-20 is equally applicable whether a married couple files separate returns or a joint return.

The modified 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 1, 2012 is affirmed.

DATED this 7th day of March, 2013.

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