

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of )  
[REDACTED] )  
TID # [REDACTED] )  
\_\_\_\_\_ )

**DECISION OF  
HEARING OFFICER**

Case No. 202100029-I

The issue before the Hearing Office is the correctness of proposed assessments of additional tax by the Individual Income Tax Audit Section (“Section”) of the Arizona Department of Revenue (“the Department”) for [REDACTED] (“Taxpayer”).

A telephonic hearing was held June 3, 2021. Present were Taxpayer and the Section’s representative. In addition, Taxpayer attempted to utilize [REDACTED] as her Power of Attorney (“POA”). The Hearing Officer (“Officer”) pointed out that that to represent the Taxpayer at the hearing, the POA needed to be either an attorney, a certified public accountant or an enrolled agent under IRS guidelines. [REDACTED] did not qualify. Taxpayer orally waived all confidentiality and [REDACTED] remained on the call, ostensibly as a non-party witness. Both parties presented evidence in the form of oral testimony and documents. At the conclusion of the hearing, it was agreed that the record would remain open to allow Taxpayer to provide additional information relating to her bankruptcy case. The Officer issued an order establishing a schedule for the submission of the additional documentation.

Since the hearing a number of events occurred. The Officer recused herself and a new Officer was designated to review the matter. In addition, a revised scheduling order was initiated. The due dates of subsequent filings were extended with the final memorandum/documents from Taxpayer due January 3, 2022. That deadline has passed and the record closed accordingly.

The new Officer has carefully reviewed all documents submitted and listened intently to the recorded hearing. Based upon a review of the record, the matter has been deemed completed and ready for a final determination.

## **FINDINGS OF FACT**

1. The Section learned that Taxpayer's 2010, 2011, 2012, 2013, 2014 and 2015 federal income tax returns were modified. The IRS assessed additional income based upon a number of adjustments to Taxpayer's schedules. This discovery was based on information from the Internal Revenue Service ("IRS") through the Department's exchange of information agreement with that agency under I.R.C. § 6103(d)(1).
2. The Section audited Taxpayer's 2010, 2011, 2012, 2013 2014 and 2015 Arizona income tax returns using the federal information. On May 22, 2019, the Section issued proposed assessments for these periods. The proposed assessments included added-on tax, statutory interest and penalties for failure to file the required returns. The assessments are listed in the Section's Exhibit "A."
3. Taxpayer timely protested each of the proposed assessments. Taxpayer raised a number of arguments in her protest, including (1) Her due process rights were violated because she was not notified of the audit (2) She had no taxable income because she was not an employee of the business and did not receive a salary and (3) The IRS abated all the tax liability. The protest documents are listed in Exhibit "B".
4. The Section mailed Taxpayer a letter outlining its position and explaining the basis of the assessments. The letter concluded that Taxpayer did not provided sufficient documents to examine that demonstrate the claims in the protest were valid. This letter is Exhibit "C".
6. Taxpayer responded to this letter with one of her own reciting the same arguments listed in the protest. In addition, it added the following assertions (1) The liability in the assessments were discharged in bankruptcy and (2) she was owed a refund because the proceeds from the involuntary sale of her homesteaded property was not received.
7. Taxpayer requested the matter be set for a formal hearing.

8. Prior to the hearing, the Section submitted its exhibits denoted as “A” to “E”. These were incorporated into the record. The exhibits contain a number of items, including Taxpayer’s arguments and the Section’s response to those arguments.

9. Taxpayer presented evidence supporting her positions at the hearing. The evidence consisted of oral testimony from both herself and [REDACTED]. Taxpayer testified that she filed a chapter 13 bankruptcy petition July 11, 2016 and that the case was involuntarily converted to chapter 7 on April 20, 2018. She testified that the case was joined with [REDACTED]’s bankruptcy case. She testified that the tax liability in the Department’s assessment was “included” in the bankruptcy and discharged. In addition, she testified she was entitled to a refund because the bankruptcy trustee sold property subject to a homestead exemption and she did not receive the proceeds from the sale.

10. The Section presented its evidence demonstrating that the assessments were issued based on IRS transcripts and that the Taxpayer failed to either report the additional tax due or to file amended tax returns. It also argued that Taxpayer’s discharge order did not include the amounts in the assessment because the assessments were not final at the time the bankruptcy petition was filed.

11. At the conclusion of the hearing, the parties agreed to leave the record open to allow Taxpayer to provide additional evidence demonstrating the taxes in the assessments were included in the discharge order. Subsequently, Taxpayer submitted additional information in the form of docket reports, pleadings and court filings from the bankruptcy.

12. The Section also submitted additional memorandum and documentation. Included was an order granting the IRS motion for summary judgment in Taxpayer’s bankruptcy case. In this order, the Federal Bankruptcy Judge ruled:

*The Judgment entered contemporaneously with this Memorandum Decision will be a final judgment, determining the tax liabilities in the IRS’s amended proofs of claim for tax years 2010 – 2015.*

13. The record for this appeal was considered closed effective January 3, 2022 as stated in the scheduling order.

14. This matter is deemed ready for a decision.

### **CONCLUSIONS OF LAW**

1. The assessment of additional income tax is presumed correct. *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 191 P.2d 729 (1948).

2. Once the presumption of correctness attaches, the taxpayer must present substantial credible and relevant evidence sufficient to establish that the assessment was erroneous. *U.S. v. McMullin*, 948 F.2d 1188 (10<sup>th</sup> Cir. 1991); *Anastasato v. C.I.R.*, 794 F.2d 884 (3<sup>rd</sup> Cir. 1986).

3. A.R.S. § 43-1001(2) defines Arizona gross income of a resident individual as the individual's federal adjusted gross income for the taxable year, computed pursuant to the Internal Revenue Code.

4. A.R.S. § 43-102(A)(1) provides that it is the intent of the Arizona legislature to adopt the provisions of the Federal Internal Revenue Code relating to the measurement of adjusted gross income for individuals so that federal adjusted gross income reported to the IRS shall be the identical sum reported to Arizona, subject only to modifications set forth in Title 43 of the Arizona Revised Statutes.

5. A.R.S. § 43-327 requires a taxpayer to report a change or correction by the IRS or to file an amended return within ninety (90) days after the final determination of the change or correction by the IRS.

6. If a taxpayer fails to report a change or correction by the IRS or fails to file an amended return as required by A.R.S. § 43-327, the Department may assess any deficiency resulting from the federal adjustments within four (4) years after the change, correction or amended return is reported to or filed with the IRS. A.R.S. § 42-1104(B)(5).

7. The Department's proposed assessments for tax years 2010, 2011, 2012, 2013, 2014 and 2015 resulted from the adjustments made by the IRS to Taxpayer's federal returns.

8. Taxpayer does not dispute that she did not report or file amended returns for Arizona for the tax years listed in the IRS assessments. Rather, Taxpayer alleges that the IRS assessments are not valid or accurate.

9. Taxpayer raised a number of arguments in support of her protest. Among these include testimony that the IRS abated all liability owed. Taxpayer failed to provide any documentation or other evidence to corroborate this claim. The Officer notes that contrary to this assertion, the IRS appeared in Taxpayer's bankruptcy case and pursued its claim. This claim is the basis for the tax liability that is at issue in this proceeding. Based upon a lack of documentation, this argument is denied.

10. Taxpayer argued that her due process rights were violated because she was not made aware of the audit. The record indicates that the Section notified Taxpayer of the audit by issuing proposed assessments. Taxpayer had a right to protest the assessments and did so. This proceeding is the notice and hearing required for due process. This argument is overruled on the merits.

11. The Officer notes that although it was challenging to navigate through the plethora of bankruptcy items, it is clear that the Federal Bankruptcy Court reviewed the IRS liability for the tax periods involved in this protest and validated them in its order dated February 7, 2019.

12. The assessments were issued May 22, 2019. Taxpayer filed a chapter 13 petition July 11, 2016. Procedurally a taxpayer has ninety (90) days to submit a protest of the assessment of individual tax liability before it becomes final. A.R.S. §42-1108(B). Here, Taxpayer timely protested the assessments. The tax liability therefore is not final until the protest is resolved.

13. The Section's representative accurately explained that the taxes in the assessment were not discharged in Taxpayer's bankruptcy. The tax liability in the assessment qualifies as a priority claim under 11 U.S.C. § 507(a)(8)(iii). This statute states that claims for taxes not assessed, but assessable ("NABA") after commencement of the case are entitled to priority status. Claims

given priority status are not subject to discharge under 11 U.S.C. § 523(a)(1)(A). Based upon this reasoning, Taxpayer's argument is denied.

14. Taxpayer provided no reasoning or authority supporting her argument that she is entitled to a refund or tax credit due to the sale of property subject to the homestead exemption. The documents indicate that the proceeds from the sale were turned over the bankruptcy trustee rather than Taxpayer. The Officer notes that the property sold appears to be property of the bankruptcy estate under 11 U.S.C. § 541. As such, the bankruptcy trustee is the proper party to administer the sale and its proceeds. Taxpayer does not explain how this process entitles her to a refund or credit from the Department. Taxpayer's argument is denied on the grounds that it is unsupported and without merit.

15. The Officer finds that the Section correctly followed its standard procedure in issuing the assessments and the Officer deems the assessments valid.

### **DISCUSSION**

In Arizona, an individual's gross income is defined as the individual's federal adjusted gross income for the taxable year, A.R.S. § 43-1001(2). Arizona taxpayers are required to report their federal adjusted gross income to Arizona. If the IRS makes changes to a taxpayer's federal adjusted gross income, there is a corresponding change that needs to be made to the taxpayer's Arizona gross income. Taxpayers are therefore required to report federal changes to the Department. If federal changes are not timely reported, the Department may issue an assessment resulting from the federal changes.

The Section issued its proposed assessments using federal information. These included the IRS changes. An additional assessment of income tax is presumed correct and it is the taxpayer's burden to overcome this presumption. A taxpayer must demonstrate with substantial credible and relevant evidence that the proposed assessment is erroneous. Taxpayer has not done so in this proceeding. Based upon this finding, Taxpayer has not overcome the presumption of correctness.

The proposed assessment 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. For Arizona purposes, interest is a part of the tax.

The Bankruptcy Court entered an order granting an IRS motion for summary judgment. This order dated February 7, 2019 specifically finds that the IRS liability for the relevant tax years is valid and accurate. The IRS tax liability forms the basis for the Arizona tax liability. Based upon the record, the Section followed the correct process in reviewing and interpreting the IRS information and issuing the assessments.

Taxpayer testified that she filed a chapter 13 petition in July 2016. She testified that this petition was "joined" with [REDACTED]'s chapter 11 petition and both were involuntarily converted to chapter 7. When a debtor files a bankruptcy petition, two noteworthy events occur. The first is the creation of the bankruptcy estate 11 U.S.C. § 541. The bankruptcy estate consists of all assets owned or claimed to be owned by the Debtor at the time the petition is filed. It also may include assets the Debtor does not possess but may come to possess. In a chapter 7 proceeding, the estate is administered by a trustee. The second event is the imposition of an automatic stay. The stay operates as a temporary injunction against collection of debts against both the debtor and the bankruptcy estate. 11 U.S.C § 362(a). The Section's issuance of the assessments is not an action to collect a debt, but rather an act to determine liability. Congress created an express exception to the automatic stay to allow a taxing authority to conduct audits and to issue assessments. 11 U.S.C. § 362(b)(9).

Whether some or part of the tax assessed is affected by a bankruptcy filing is a different question from whether the *issuance* of an assessment is valid. In theory, a discharge order would affect the *collection* of a debt subject to discharge. The discharge order would not, however, invalidate the *existence* of the debt. In other words, the discharge order acts as a permanent

injunction against the debtor's personal liability of a debt that is subject to the discharge order. The debt itself, however, still exist. 11 U.S.C § 524.

A discharge order does not affect all debts. 11 U.S.C. § 523 contains an extensive lists of debts not subject to a chapter 7 discharge. Relevant here are those claims entitled to priority status. Under 11 U.S.C. § 507(a)(8)(iii), claims for taxes not assessed, but assessable after commencement of the case are entitled to priority status and therefore not subject to discharge. 11 U.S.C § 523(a)(1)(A). The evidence indicates that the Section issued the assessments in May 2019 and that Taxpayer timely protested the assessments. The assessments are not final until the protest is resolved. Taxpayer filed her bankruptcy petition in July 2016. Therefore, the taxes listed in the assessment could not have been assessed because the Section was not aware of their existence when the petition was filed. The statutory history for the NABA provision expressly states that its main function is to provide priority treatment for tax claims following an assessment of additional liability following an audit.<sup>1 2</sup>

The Officer concludes that the automatic stay does not apply to this hearing and that the taxes in the assessment are not subject to the discharge order.

### **CONCLUSION**

The question before this Office is whether the Section properly issued the assessments. Based on the evidence submitted and arguments advanced, the Office concludes that Taxpayer has not met his burden in overcoming the presumption that the assessments were properly issued. The protest is deemed denied and Section's proposed assessments is affirmed.

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<sup>1</sup> Among the other types of tax claims entitled to priority status are those where the returns are filed within three years of the petition, where the returns were filed late, within two years of the petition, and taxes filed within 240-days of the petition. The logic behind providing these claims receiving priority status is that the taxing authority did not have a reasonable opportunity to collect the tax debt before the bankruptcy petition imposed the automatic stay. Similarly, the NABA rule applies for the same reason - the tax authority was not aware of the obligation and did not have a reasonable opportunity to exercise its state law remedies to collect it.

<sup>2</sup> The record indicates that the Taxpayer did not file required amended returns to disclose the additional tax liability. Liability for taxes from unfiled returns are also not subject to discharge in chapter 7. 11 U.S.C. § 523(a)(1)(B)(i)



DATED this 27<sup>th</sup> day of January, 2022.

ARIZONA DEPARTMENT OF REVENUE  
HEARING OFFICE

[REDACTED]  
Hearing Officer

Originals of the foregoing sent by  
Certified mail to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue  
Individual Income Tax Audit Section