BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of [REDACTED] UTI # [REDACTED]	))))))	DECISION OF HEARING OFFICER Case No. 201100112-I

A hearing was held on June 7, 2011 in the matter of the protest of [REDACTED] (Taxpayers) to an assessment of income tax, interest and penalty by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2005.

This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayers filed their resident Arizona income tax return for tax year 2005.
2. Taxpayers' Arizona income tax return was electronically filed on [REDACTED].
3. The Internal Revenue Service (IRS) audited Taxpayers' 2005 federal income tax return and disallowed Taxpayers' deduction for alimony payments in the amount of $[REDACTED].
4. Taxpayers did not report the federal change to the Department nor did Taxpayers file an amended return with the Department to reflect the federal change.
5. Through an exchange of information agreement with the IRS (I.R.C. § 6103(d)(1)), the Section learned of the federal change.
6. The Section issued Taxpayers a proposed deficiency assessment dated [REDACTED] disallowing Taxpayers' deduction for alimony payments in the amount of $[REDACTED].
7. The assessment also reduced Taxpayers' itemized deduction due to a limitation on the itemized deductions of high income taxpayers.

8. The proposed assessment calculated interest at the statutory rate and included a penalty for failure to file when due.

9. Taxpayers timely protested the assessment stating that the Department had previously allowed a deduction in a prior year for the alimony payments at issue here.

10. Taxpayers had been audited by the Department for tax year 2001 and Taxpayers protested.

11. The Section granted Taxpayers' protest of the prior assessment for tax year 2001 while the protest was at the formal hearing level.

12. The Hearing Officer issued an order stating that the Section had granted Taxpayers' protest for tax year 2001 and the case was therefore closed at the Hearing Office.

13. Taxpayers submitted a copy of a Decree of Dissolution of Marriage ("Decree") dated [REDACTED] regarding Taxpayer [REDACTED] and [REDACTED], his ex-wife.

14. Paragraph 2 of the Decree provided that Husband ([REDACTED]) will pay to his Wife $[REDACTED] per month for 24 months only or until the death of either party or Wife's remarriage.

15. Paragraph 3 of the Decree stated:

> "3. Husband shall pay to Wife the sum of $[REDACTED] to equalize the division of community assets and debt. Wife is awarded a judgment for that amount but she may not execute on the judgment as long as the indebtedness is paid at the rate of $[REDACTED] per month. (This assumes 120 equal monthly payments with interest at 10% per annum). This amount shall be secured by Husband's interest in the three businesses, [REDACTED], [REDACTED] and

> [REDACTED]. In the event Husband files bankruptcy, the Court has considered the monthly payments to be in the nature of spousal maintenance to Wife, as these payments are necessary for her to maintain a reasonable standard of living. If Husband should elect not to pay the indebtedness in monthly installments at 10% interest rate, and pays the indebtedness in a lump sum, Wife would be entitled to seek an increase in the amount of spousal maintenance because it is not expected that she would be able to invest the funds and receive a 10% interest rate on the investment."

16. The Decree did not provide that the payments of $[REDACTED] per month would stop upon the death of either party or upon Wife's remarriage.

17. The amount disallowed as alimony for tax year 2005 represented 12 monthly payments of $[REDACTED].

18. The issue involved in the assessment for tax year 2001 was the deductibility of the payments under Paragraph 3 of the Decree.

CONCLUSIONS OF LAW

1. Arizona Revised Statutes (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 (I.R.C.).

2. 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 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.

3. Arizona taxpayers may deduct on their Arizona income tax return itemized deductions calculated under the Internal Revenue Code. A.R.S. § 43-1042.

4. I.R.C. § 215(a) allows a deduction for alimony or separate maintenance payments paid during such individual's taxable year.

5. I.R.C. § 215(b) defines alimony or separate maintenance payments as any alimony or separate maintenance payment defined in section 71(b) which is includible in the gross income of the recipient under section 71.

6. I.R.C**.** § 71(b)(1) defines alimony or separate maintenance payments as:

> (A) payments received by (or on behalf of) a spouse under a divorce or separation instrument,
>
> (B) the divorce or separation instrument does not designate payment as a payment which is not includible in gross income under section 71 and not allowable as a deduction under section 215,
>
> (C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and
>
> (D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

7. Paragraph 3 of the Decree did not provide that there would be no liability for payments to be made after the death of Wife.

8. Paragraph 3 of the Decree contemplated that the entire amount awarded in Paragraph 3 of the divorce decree would be paid.

9. Payments made by Taxpayers pursuant to Paragraph 3 of the Decree did not meet the definition of alimony or separate maintenance payments and were not deductible under I.R.C. § 215(a).

10. The payments under Paragraph 3 of the Decree were therefore not deductible under A.R.S. § 43-1042 for Arizona income tax purposes.

11. Under the doctrine of res judicata, a final judgment on the merits of an action precludes the parties from relitigating issues that were or could have been raised in that action. *Allen v. McCurry*, 449 U.S. 90, 101 S.Ct. 411 (1980).

12. In the determination of any case arising under title 42 or title 43, the rule of res judicata is applicable only if the liability involved is for the same year or period as was involved in another case previously determined under title 42 or title 43. A.R.S. § 42-1004(C).

13. Because the assessment for tax year 2005 involves a different period from that involved in the prior assessment, the doctrine of res judicata is not applicable.

14. 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.

15. A.R.S. § 42-1123(C) recognizes the time value of money, and thus requires a taxpayer that is holding or using money that rightfully belongs to the State to pay interest for the use of that money. *Valencia Energy Co. v. Arizona Dep't of Revenue,* 191 Ariz. 565, 959 P.2d 1256 (1998).

16. A.R.S. § 42-1125(A) imposes a penalty for failure to file an Arizona income tax return when due.

17. The failure to file when due penalty may be abated only if the failure to file "is due to reasonable cause and not due to wilful neglect." A.R.S. § 42-1125(A).

18. Taxpayers have presented no evidence to show that their failure to file when due was due to reasonable cause and not due to wilful neglect.

DISCUSSION

The issue in this case is whether Taxpayers may deduct monthly payments of $[REDACTED] made by Taxpayers to [REDACTED], Taxpayer [REDACTED] ex-wife. The payments were made pursuant to Paragraph 3 of the divorce decree between [REDACTED] and [REDACTED]. Taxpayers contend the payments were intended by the decree to be alimony and were therefore deductible by Taxpayers.

Arizona taxpayers may deduct on their Arizona income tax return itemized deductions calculated under the Internal Revenue Code. I.R.C. § 215 provides a deduction for alimony. I.R.C. § 71(b) requires that the four conditions listed in Conclusion of Law No. 6. be met before a payment may be deducted as alimony. Only the fourth condition, that the obligation to make payments stops on the death of the payee spouse (the ex-wife in this case), is at issue here.

Paragraph 3 of the Decree awarded Wife a lump sum judgment in the amount of $[REDACTED] and the amount was secured by the Husband's interest in three businesses. The Decree did not award the Wife monthly payments, but provided that the Wife could not execute on the judgment as long as the indebtedness was paid at the rate of $[REDACTED] per month. The Decree did not explicitly provide that the payments would terminate upon [REDACTED] death.

Even if the divorce decree fails to specify that the payments terminate upon the payee's death, if payments will necessarily terminate upon the payee's death by operation of state law, the payments may still qualify as alimony payments. *Hoover v. Commissioner of Internal Revenue*, 102 F.3d 842 (6 Cir., 1996). A.R.S. § 25-327(B) provides that unless otherwise agreed in writing or expressly provided in the decree, the obligation to pay future maintenance is terminated on the death of either party or the remarriage of the party receiving maintenance. Because Paragraph 3 of the Decree awarded the Wife a lump sum amount of $[REDACTED] and Wife could execute on the judgment if [REDACTED] failed to make the monthly payments, under the Decree the

obligation to make payments would not have terminated on the death of either party to the Decree. Therefore it cannot be said that the payments would necessarily terminate upon the payee's death by operation of state law.

The situation here is analogous to the situation addressed by the court in the *Hoover* case. The Court stated, 102 F.3d at 848:

> Nothing in the language of the divorce decree itself indicated that the payments to Mrs. Hoover would terminate on her death. In fact, the decree specifically obligated Mr. Hoover to pay her the definite sum of $521,640 in installments "until said amount is paid in full." Such payment was not made contingent on any factor or event. Furthermore, Mrs. Hoover received a lien on Mr. Hoover's shares in Stark Ceramics as security for that payment, with a requirement that Mr. Hoover provide a letter of credit from a bank guaranteeing the payment or that he pledge sufficient stock with an escrow agent, with such pledge to "remain in full force and effect until all of the alimony has been paid in full." We have no reason to conclude that Mr. Hoover's obligation to pay Mrs. Hoover the full amount terminates upon her death.

Similarly here, the decree obligated [REDACTED] to pay his ex-wife the definite sum of $[REDACTED], payable monthly with 10% interest. The obligation was secured by [REDACTED] interest in three businesses. There is no reason to conclude that [REDACTED] obligation to pay [REDACTED] the full amount would terminate at her death (or remarriage). The payments therefore failed to meet the definition of alimony set forth in I.R.C. § 71(b)(1) and the payments were not deductible for federal or state income tax purposes.

Taxpayers also argued that an assessment involving payments under Paragraph 3 of the Decree for tax year 2001 was previously abated by the Hearing Office. In the 2001 case the Hearing Officer entered an order stating that the Individual Income Tax Audit Section advised the Hearing Office that Taxpayers' protest had been granted. A Final Order was thus entered closing the 2001 case. The Hearing Officer did not issue a ruling addressing the deductibility of the payments and the record does not show in either case why the 2001 protest was granted.

The current assessment involves tax year 2005. While the doctrine of res judicata would preclude any relitigation or reconsideration of tax year 2001, the doctrine

does not preclude the assessment for tax year 2005. The issue for tax year 2005 has to be decided on its own merits.

The assessment included interest and a penalty for failure to file when due. 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.

Interest is not a penalty, but is simply compensation to the state for the lost time-value of money received after the due date. *Valencia Energy Co. v. Arizona Dep't of Revenue, supra*. (Non-punitive interest is, after all, nothing more than compensation for the use of money. The taxpayer had the benefit of using the funds before paying the tax claim and, in the legal sense, suffers no loss by reason of paying interest on the money it retained in its possession.)

The assessment also included a penalty for failure to file when due. The print-out of Taxpayers' electronically filed return for tax year 2005 indicates that it was filed on [REDACTED], which was past the due date of the return. A.R.S. § 42-1125(A) provides in part:

> A. If a taxpayer fails to make and file a return for a tax administered pursuant to this article on or before the due date of the return or the due date as extended by the department, then, unless it is shown that the failure is due to reasonable cause and not due to wilful neglect, four and one-half per cent of the tax required to be shown on such return shall be added to the tax for each month or fraction of a month elapsing between the due date of the return and the date on which it is filed. The total penalty shall not exceed twenty-five per cent of the tax found to be remaining due. . . .

The failure to file when due penalty may be abated only if the failure to file "is due to reasonable cause and not due to wilful neglect." A.R.S. § 42-1125(A). "Reasonable cause" is generally defined to mean the exercise of "ordinary business care and prudence." *Daley v. United States,* 480 F. Supp. 808 (D.N.D. 1979). Taxpayers have not established reasonable cause. Therefore, the imposition of the failure to file when due penalty is upheld.

Based on the foregoing, the Section's proposed assessment dated [REDACTED] is affirmed.

DATED this 24th day of June, 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