

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of )

[REDACTED] )

TID # [REDACTED] )

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DECISION OF  
HEARING OFFICER

Case No. 202100037-I

The issue before the Hearing Office is the propriety of the proposed assessments of additional tax by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) against [REDACTED] (Taxpayers).

At the hearing held on July 29, 2021, it was agreed that the record in this matter would remain open to allow Taxpayers to provide additional information. Taxpayers and the Section submitted their respective memoranda. This matter is now ready for a ruling.

FINDINGS OF FACT

1. Taxpayers filed Arizona resident income tax returns for tax years 2017 and 2018 and claimed a credit for taxes paid to California.
2. Taxpayers elected to participate in California group nonresident returns for tax years 2017 and 2018.
3. On November 27, 2019, the Section issued proposed assessments for the tax years 2017 and 2018 that disallowed Taxpayers' claimed credit for taxes paid to California in the amounts of \$[REDACTED] for 2017 and \$[REDACTED] for 2018.
4. The proposed assessments included statutory interest. No penalties were assessed.
5. Taxpayers protested and stated that the authority cited by the Department, A.R.S. § 43-1071, was being misapplied. Taxpayers claimed that under a newly enacted subsection (F), a participant in a composite return may claim a credit for taxes paid to the other state and disallowing the credit would cause double taxation on California derived income.

6. The Section sent Taxpayers a letter dated February 14, 2020 and Taxpayers responded and requested a formal hearing.
7. On January 7, 2021, the Section sent Taxpayers a letter addressing Taxpayers' position that A.R.S. § 43-1071(F) was being misapplied. The Section explained that A.R.S. § 43-1071(F) states that "an individual who participates in a composite income tax return in another state may claim a credit for taxes paid to the other state *if the taxpayer meets all of the requirements of this section* and the taxes paid to the other state are imposed on and paid directly by the individual taxpayer and not the entity." Under A.R.S. § 43-1071(A)(2), the credit is not allowed if the other state allows a credit for residents of Arizona. In this case, because California allows Arizona residents to take a credit for taxes paid to Arizona on their California nonresident return, individuals are not allowed to take the credit for taxes paid to California on their Arizona resident return.
8. At the hearing held on July 29, 2021, [REDACTED] testified that he and his wife participated in group nonresident returns in California for the tax years 2017 and 2018. In addition, he stated that California does not allow a credit for taxes paid to another state on a group or composite nonresident return. [REDACTED] argued that he met the requirements of A.R.S. § 43-1071(F) and the credits were incorrectly disallowed in the proposed assessments for 2017 and 2018.
9. At the hearing, it was agreed that the record in this matter would remain open to allow Taxpayers to provide additional information. Taxpayers and the Section submitted their respective memoranda.
10. This matter is ready for a written determination by the Hearing Office.

#### CONCLUSIONS OF LAW

1. The presumption is that an assessment of additional income tax is 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. Arizona Revised Statutes (A.R.S.) § 43-102(A)(4) states that a resident of Arizona is subject to income tax on all of his income wherever derived.
4. A.R.S. § 43-1071(A) provides that “residents are allowed a credit . . . for net income taxes imposed by and paid to another state or country on income taxable under this chapter.”
5. A.R.S. § 43-1071(A)(2) states that “[t]he credit is not 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.”
6. A.R.S. § 43-1071(F) provides the following:

An individual who participates in a composite income tax return in another state may claim a credit for taxes paid to the other state if the taxpayer meets all of the requirements of this section and the taxes paid to the other state are imposed on and paid directly by the individual taxpayer and not the entity. For the purposes of this subsection, taxes are considered to be imposed on and paid directly by the individual under one or more of the following circumstances:

  1. The individual makes direct payment to the other state.
  2. The individual makes direct payment to the entity filing the composite tax return.
  3. The entity charges the individual’s loan account for the amount of the tax.
  4. The entity reduces the individual’s capital account.
7. “For purposes of computing ‘taxable income of a nonresident or part-year resident’ under paragraph (1) of subdivision (i) of Section 17041, in the case of nonresident taxpayers

the gross income includes only the gross income from sources within this state.” Cal. Rev. & Tax. Code § 17951(a).

8. “Subject to the following conditions, nonresidents shall be allowed a credit against the “net tax (as defined by Section 17039) for net income taxes imposed by and paid to the state of residence . . . on income taxable under this part”. Cal. Rev. & Tax Code § 18002.

9. Cal. Rev. & Tax Code § 17039 defines “net tax” as

(a) Notwithstanding any provision in this part to the contrary, for the purposes of computing tax credits, the term “net tax” means the tax imposed under either Section 17041 or 17048 plus the tax imposed under Section 17504 (relating to lump-sum distributions) less the credits allowed by Section 17504 (relating to personal exemption credits) and any amount imposed under paragraph (1) of subdivision (d) and paragraph (1) of subdivision (e) of Section 17560. Notwithstanding the preceding sentence, the “net tax” shall not be less than the tax imposed under Section 17504 (relating to the separate tax on lump-sum distributions), if any. Credits shall be allowed against “net tax” in the following order:

...

(6) Credits for taxes paid to other states allowed by Chapter 12 (commencing with Section 18001).

10. “There shall be imposed for each taxable year upon the taxable income of every nonresident or part-year resident . . . a tax as calculated in paragraph (2).” Cal. Rev. & Tax Code § 17041(b)(1).

11. Taxpayers elected to file California group nonresident returns for tax years 2017 and 2018.

12. Taxpayers could have claimed an other state tax credit had they chosen to file individual returns in California for the tax years 2017 and 2018. The California other state tax credit was not available for group returns for the tax years 2017 and 2018.
13. Taxpayers have not overcome the presumption of correctness of the Section's proposed assessment.
14. The Section properly disallowed the credit claimed for taxes paid to California for the tax years 2017 and 2018.
15. 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.
16. The Section's proposed assessments for tax years 2017 and 2018 were proper.

#### DISCUSSION

The Taxpayers derive income from a multi-state partnership with offices in Arizona, California, Illinois, Michigan, Nevada, Pennsylvania, and Washington D.C. Taxpayers filed Arizona resident income tax returns for tax years 2017 and 2018 and claimed a credit for taxes paid to California. Taxpayers elected to participate in California group nonresident returns for tax years 2017 and 2018. On November 27, 2019, the Section issued proposed assessments for the tax years 2017 and 2018 that disallowed Taxpayers' claimed credit for taxes paid to California. At issue is whether Taxpayers are allowed a credit on their Arizona resident tax returns for taxes paid to another state under A.R.S. § 43-1071.

A.R.S. § 43-1071(A) provides that "residents are allowed a credit . . . for net income taxes imposed by and paid to another state or country on income taxable under this chapter." However, this credit is limited by A.R.S. § 43-1071(A)(2) which states that "[t]he credit is not 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." A.R.S. § 43-1071(F) provides the following:

An individual who participates in a composite income tax return in another state may claim a credit for taxes paid to the other state *if the taxpayer meets all of the requirements of this section* and the taxes paid to the other state are imposed on and paid directly by the individual taxpayer and not the entity. For the purposes of this subsection, taxes are considered to be imposed on and paid directly by the individual under one or more of the following circumstances:

1. The individual makes direct payment to the other state.
2. The individual makes direct payment to the entity filing the composite tax return.
3. The entity charges the individual's loan account for the amount of the tax.
4. The entity reduces the individual's capital account.

(emphasis added)

As explained in California Legal Ruling 2017-01, Arizona provides a credit to California residents for tax paid to California on income sourced to Arizona, so it is a “reverse credit state,” and an Arizona taxpayer is entitled to claim a California “other state” tax credit in determining taxes payable to California on California-source income.<sup>1</sup> However, the other state tax credit is not allowed on the California nonresident group return. As provided in 2017 FTB Publication 1067 “Guidelines for Filing a Group Form 540NR,

Individual credits, such as the personal, blind, senior, or dependent exemption credits and the other state credit, are not allowed on the group nonresident return. To use individual credits, such as the other state tax credit, the individual should file a separate Form 540NR and should not be included in the group return.

This is further clarified under the heading “Residents of Arizona, Guam, Oregon, and Virginia,”

If you file your own individual return, you may qualify to claim the other state tax credit. This credit is not allowed if you are included in the group return. Thus you may want to consult with a tax advisor before making the irrevocable election to be included in the 2017 group return.

2017 FTB Publication 1067 “Guidelines for Filing a Group Form 540NR

In California, the credit for other taxes paid is available to taxpayers if they file an individual nonresident return. In this case, Taxpayers chose to file a group return for tax years

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<sup>1</sup> See Situation One in California Legal Ruling 2017-01. “The payment of the Arizona tax meets the requirement under RTC Section 18002 that the tax imposed and paid to the other state be a net income tax because, as determined by California law, the tax was paid on A’s pro rata share of Z’s ordinary income from its trade or business, which was computed by deducting all allowable ordinary and necessary business expenses from total gross income. Because Arizona is a reverse credit state and that taxes paid to Arizona on A’s pro rata share of Z’s income is a net income tax, the California OSTC is allowed.”

2017 and 2018. Taxpayers fail to meet the requirements of A.R.S. § 43-1071(F) because “[t]he credit is not 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” under A.R.S. § 43-1071(A)(2). California allows Arizona residents a credit against the taxes imposed in California for taxes paid in Arizona if taxpayers file an individual return. Taxpayers forfeited that credit when they chose to file a group nonresident return. A.R.S. § 43-1071(F) allows taxpayers who file a group return in another state the *same* credit as those filing an individual return in another state. It does not, however, create a new credit for taxes paid to California, which would otherwise be unavailable for individual filers, merely because Taxpayers filed a group return. The Department correctly disallowed Taxpayers’ claimed credits for taxes paid to another state for tax years 2017 and 2018.

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, therefore, interest is a part of the tax and generally may not be abated unless the tax to which it relates is found not to be due for whatever reason.

Based on the foregoing, the Section’s proposed assessments for tax years 2017 and 2018 dated November 27, 2019 are affirmed.

DATED this 14<sup>th</sup> day of December, 2021.

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