BEFORE THE STATE BOARD OF TAX APPEALS
STATE OF ARIZONA
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Phoenix, Arizona 85007
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EDWARD E. and RUTH S. DUNGAN, Appellants, vs. ARIZONA DEPARTMENT OF REVENUE, Appellee.	)	Docket No. 1951-06-I NOTICE OF DECISION FINDINGS OF FACT AND CONCLUSIONS OF LAW

The State Board of Tax Appeals, having considered all evidence and arguments presented, and having taken the matter under advisement, finds and concludes as follow:

FINDINGS OF FACT

In 1978, Edward E. and Ruth S. Dungan ("Appellants") purchased income property in the State of Washington for $74,723. On April 28, 1994, Appellants sold the Washington property and elected to defer recognition of gain on the income as part of an exchange in kind transaction under section 1031 of the Internal Revenue Code ("IRC"). Several days later, as part of the exchange, Appellants used the proceeds from the sale of the Washington property to purchase income property in Arizona for $124,023. Pursuant to IRC § 1031(d), Appellants acquired a carryover basis in the Arizona property from the Washington property, meaning it had the same basis as the Washington property transferred in the 1994 exchange.

Appellants became Arizona residents in 1998 and remained Arizona residents until 2004. In June, 2000, Appellants sold the Arizona property for $178,500 and reported a taxable gain of $103,777 (the $178,500 sale price of the Arizona property less the $74,723 deferred basis of the Washington property) on their 2000 Federal individual tax return. Based on information obtained through an

exchange of information agreement with the Internal Revenue Service, the Arizona Department of Revenue ("Department") audited Appellants' 2000 Arizona resident income tax return and determined that Appellants had improperly claimed a deduction of $49,300. Appellants had reached this figure by subtracting the $54,477 actual gain on the sale of the Arizona property (i.e., the $178,500 sale price less the $124,023 purchase price) from the $103,777 gain reported on their federal return. Appellants argue that $49,300 is not subject to Arizona tax because this gain resulted from the sale of the Washington property sold in 1994 when they were residents of Washington and not Arizona.

Subsequently, the Department issued a proposed assessment of additional tax, a late payment penalty, and interest for tax year 2000. Appellants protested the assessment to the Department's Hearing Officer, who upheld the assessment. Appellants then protested to the Director of the Department, who affirmed the Hearing Officer's decision. Appellants now timely appeal to this Board.

DISCUSSION

The issue before the Board is whether the Department properly disallowed the $49,300 deduction claimed by Appellants.

A.R.S. § 43-102(A)(4) states that it is the "[i]ntent of the legislature . . . to impose on each resident of this state a tax measured by taxable income wherever derived." Appellants were residents of Arizona during 2000; therefore, all of their income wherever derived was subject to Arizona tax, including the $49,300 amount. It is further the intent of the legislature, under A.R.S. 43-102(A)(1), to adopt the provisions of the IRC relating to the measurement of adjusted gross income for individuals so that adjusted gross income reported to the Internal Revenue Service shall be *the identical sum reported to Arizona*, subject only to modifications set forth in Title 43 of the Arizona Revised Statutes. Therefore, Appellants were required to report on their 2000 Arizona return the full $103,777 gain reported on their 2000 federal return.

Appellants chose to structure their 1994 transaction to avoid recognition of gain at the time they sold the property in Washington. Consequently, their basis in the Arizona property was $49,300 less than it would have been had they recognized the gain on the 1994 exchange. As a result, the deferred gain must be recognized upon the subsequent sale at both the federal and state levels. The U.S. Supreme Court declared: "[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not." *C.I.R. v. National Alfalfa Dehydrating & Mining Co.*, 417 U.S. 134, 149 (1979) *citing Higgins v. Smith*, 308 U.S. 473, 477 (1940).

Appellants additionally argue that they were entitled to deduct the $49,300 because they paid an excise transfer tax in Washington on the exchange of their Washington property in 1994. While Arizona does provide a "credit against the taxes imposed by this chapter for net income taxes imposed by and paid to another state or country on income taxable under this chapter," Appellants did not pay any "net income taxes" in Washington on the 1994 exchange of their property. *See* A.R.S. 43-1071(A). The Washington excise transfer tax was based on a percentage of the selling price (without regard to basis or gain) of the property transferred. Washington Revised Code § 82.45.60. It was not a tax on "net income" as required by A.R.S. § 43-1071. *See, generally, Ariz. Dep't of Rev. v. Short*, 192 Ariz. 322, 965 P.2d 56 (App. 1998). Also, the excise transfer tax was paid in 1994 not 2000.

The right to a deduction does not exist in the absence of statutory authority. See *Ariz. Dep't of Rev. v. Transamerica Title Ins. Co.*, 124 Ariz. 417, 604 P.2d 1128 (1979). There is no Arizona law that allows Appellants to take the $49,300 deduction at issue. Further, under A.R.S. 42-1125(D), the late payment penalty may be abated only if the failure to timely pay is due to reasonable cause and not due to willful neglect. Appellant have not shown that their failure to timely pay was due to reasonable cause. Finally, 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. The tax is due in this case and the associated interest cannot be abated.

CONCLUSIONS OF LAW

1. The Department properly disallowed the $49,300 deduction claimed by Appellants. A.R.S. § 43-102(A); *see Ariz. Dep't of Rev. v. Transamerica Title Ins. Co.*, 124 Ariz. 417, 604 P.2d 1128, (1979).

2. Appellants have not shown that their failure to timely pay was due to reasonable cause; therefore, they are liable for the penalty assessed. A.R.S. 42-1125(D).

3. The interest assessed may not be abated. A.R.S. 42-1123(C).

ORDER

THEREFORE, IT IS HEREBY ORDERED that the appeal is denied and the final order of the Department is affirmed.

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This decision becomes final upon the expiration of thirty (30) days from receipt by the taxpayer, unless either the State or taxpayer brings an action in superior court as provided in A.R.S. § 42-1254.

DATED this 1st day of May, 2007.

STATE BOARD OF TAX APPEALS

Janice C. Washington

JCW:ALW

CERTIFIED

Copies of the foregoing
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