STATE BAR OF ARIZONA

tax law news

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contents

We welcome comments about this newsletter and invite you to suggest topics or submit an article for consideration.

Tax Law Section of the State Bar of Arizona
4201 N. 24th St., Suite 100, Phoenix, AZ 85016

message from the chair

This fiscal year promises to be an eventful one for the Tax Section and I am pleased to have the opportunity to experience it with you as Chair of the Tax Section.

Each year the Tax Section offers…

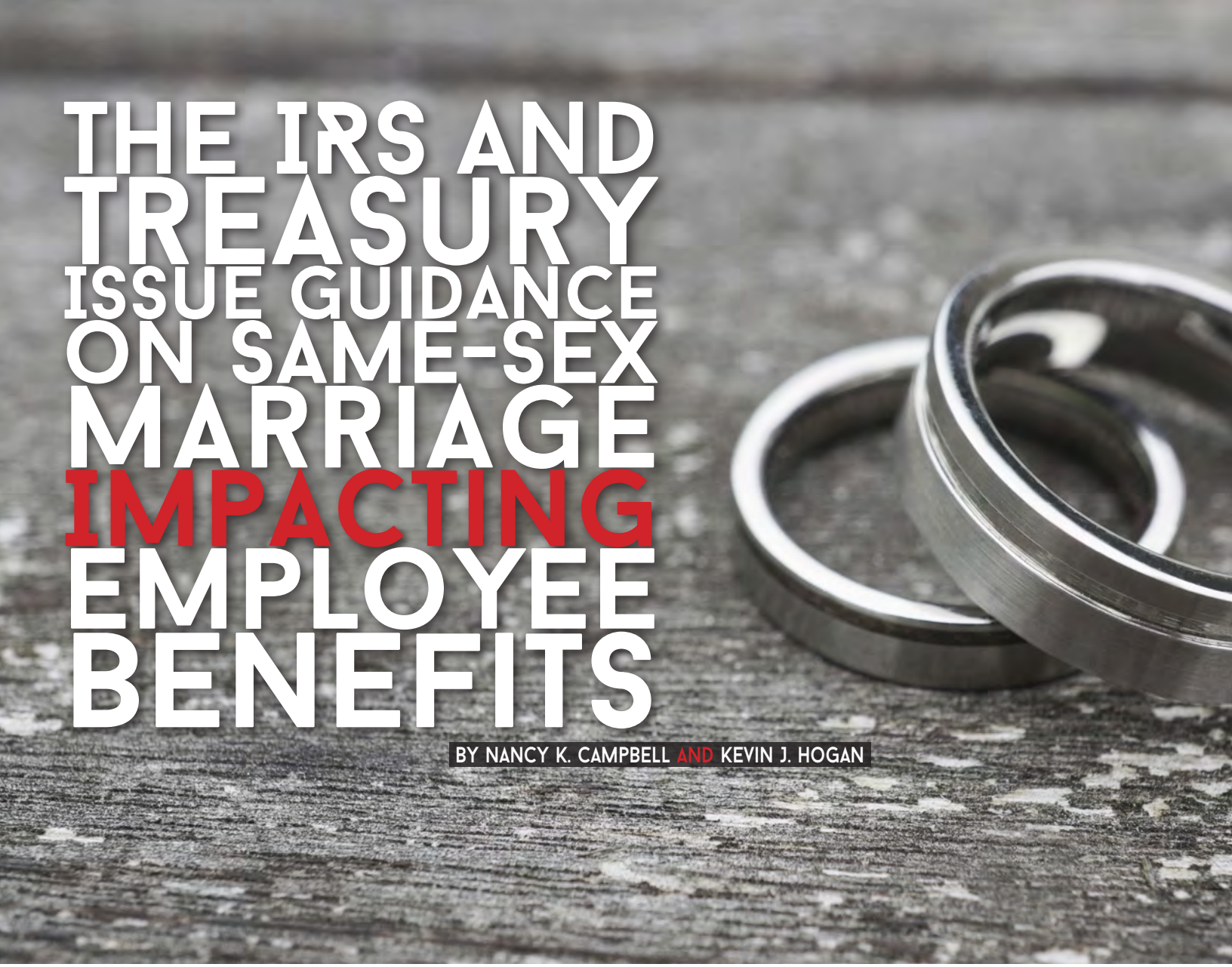
- affordable continuing education programs, including monthly luncheons and an extended program at the State Bar Convention,
- regular networking opportunities with local practitioners,
- an opportunity to learn from and meet United States Tax Court judges,
- publication of a bi-annual newsletter with upcoming events and articles of interest to tax practitioners (including the opportunity to submit articles for publication),
- scholarships to Arizona law students,
- updates regarding recent tax developments,
- pro bono opportunities, including through the IRS' Volunteer Income Tax Assistance ("VITA") program and Community Legal Services' Volunteer Lawyers Program ("VLP"), and
- mentoring opportunities to less experienced attorneys and law students.

Although each of these opportunities is deserving of special attention, I would like to encourage Tax Section members to specifically consider serving as a mentor and/or providing your services in a pro bono capacity during this fiscal year.

As background, the State Bar mentor program was established to foster informal professional relationships between experienced and less-experienced attorneys and to help law students gain insight about the legal profession and better prepare them for the practice of law. Participation as a mentor through the Mentor Program qualifies as voluntary pro bono public service under Ethical Rule 6.1 and mentors in the Mentor Program may receive up to 2.0 hours of ethics CLE credit. Please contact Michael Harrel (**michael.r.harrel@irscounseltreas.gov**) or Michael Payne (**mjpayne@outlook.com**) for more information about mentoring a young lawyer or law student interested in tax law.

For more information regarding volunteering your services through VITA or taking on a VLP case, please contact me at **clowry@swlaw.com**, and I will place you in touch with the appropriate person. Please also let me know if you would be interested in becoming more involved in the Tax Section.

— Carlene Lowry, Section Chair
Snell & Wilmer L.L.P.



THE IRS AND TREASURY ISSUE GUIDANCE ON SAME-SEX MARRIAGE IMPACTING EMPLOYEE BENEFITS

BY NANCY K. CAMPBELL AND KEVIN J. HOGAN

On June 26, 2013, the United States Supreme Court, in *United States v. Windsor*, held that Section 3 of the Defense of Marriage Act ("DOMA") is unconstitutional as a deprivation of the equal liberty of persons that is protected by the due process clause of the Fifth Amendment of the United States Constitution. Before it was struck down, Section 3 of DOMA had provided that for purposes of federal law, "marriage" means only a legal union between one man and one woman as husband and wife.

The *Windsor* ruling affects nearly every employee benefit plan. This article will briefly discuss its effect on qualified retirement plans. As a result of *Windsor*, the DOMA definition no longer applies. When Section 3 of DOMA was the law, employers could not provide many employee benefits and protections to same-sex spouses. The opposite is now true. Now that Section 3 of DOMA has been overturned, employers must extend most employee benefits and protections to legally married same-sex spouses.

In response to the Supreme Court's ruling in *Windsor*, the Internal Revenue Service (the "IRS") and the Department of Treasury ("Treasury") have released new guidance on the treatment of same-sex spouses. This guidance provides direction on some of the issues employers are facing in the wake of the Supreme Court's ruling.

IRS and Treasury Ruling for Purposes of Federal Tax Law and Employee Benefits

On August 30, 2013, in Revenue Ruling 2013-17, the IRS and Treasury ruled that same-sex married couples will be treated as married for all federal tax purposes as long as they were married in a jurisdiction that recognizes same-sex marriages, which is known as a "state of celebration" standard[1]. The IRS supplemented this ruling by releasing *Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law*, which provides that the terms "spouse," "husband and wife," "husband" and "wife" include an individual

married to a person of the same sex if the individuals are lawfully married under state law[2], and the term "marriage" includes such a marriage between individuals of the same sex[3]. This means lawfully married same-sex spouses will be treated the same as opposite-sex spouses with respect to federal mandates that apply to employee benefit plans.

The guidance also provides that these terms do "not include individuals who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as marriage under the laws of that state."

The guidance was effective on September 16, 2013, and applies prospectively. The IRS has indicated that it will publish further guidance on any retroactive application of the Supreme Court's opinion in *Windsor* to employee benefit plans. The IRS anticipates that "future guidance will provide sufficient time for plan amendments and any necessary corrections so that plans and benefits will retain favorable tax treatment for which they otherwise qualify."

Required Changes to Qualified Retirement Plans

In order to maintain their qualified tax status, retirement plans are required to offer several spousal benefits and protections. Based on Windsor and the IRS guidance discussed above, employers are now required to offer certain benefits and protections to same-sex spouses, such as:

- defined benefit pension plans must offer qualified joint and survivor annuities ("QJSAs") and qualified pre-retirement survivor annuities ("QPSAs") to same-sex spouses;
- qualified plans must require same-sex spouses to consent to beneficiary designations in favor of anyone other than the same-sex spouse;
- qualified plans must honor qualified domestic relations orders ("QDROs") in favor of same-sex spouses; and
- qualified plans must treat same-sex spouses as spouses for purposes of the required minimum distribution provisions.

> "When Section 3 of DOMA was the law, employers could not provide many employee benefits and protections to same-sex spouses."

The application of these protections to same-sex spouses can have some interesting results. For example, any beneficiary designation in favor of someone other than a participant's same-sex spouse is now invalid and, by default, the beneficiary will be the same-sex spouse. Same-sex married employees who intend a different result must complete a new beneficiary designation form and obtain spousal consent, the same way that opposite-sex couples must. Another interesting result is that QDROs in favor of same-sex spouses that previously could not be honored are likely valid and should be reconsidered.

Action Items

Although we expect the regulators to issue additional guidance on these issues, employers should start moving forward with their compliance efforts by amending plans, summary plan descriptions, and employee handbooks to reflect the new definition of "spouse."

ENDNOTES

1. Note that for purposes of the Family and Medical Leave Act, the current Department of Labor guidance requires that the spouse live in a state that legally recognizes the marriage. This is known as a "state of residence" standard.
2. For purposes of the ruling, "state" means any domestic or foreign jurisdiction having the legal authority to sanction marriages.
3. The Department of Labor published near identical guidance in Technical Release 2013-04.









FIVE ISSUES WINDSOR DOES NOT SOLVE FOR ARIZONA TAXPAYERS

By Brent W. Nelson, Snell & Wilmer L.L.P.

The United States Supreme Court recently held that for federal law purposes, same-sex marriages are treated the same as opposite-sex marriages. In response to that ruling, the Internal Revenue Service ("Service") and the Department of Labor (which administers the Employee Retirement Income Security Act "ERISA") each announced that those agencies would recognize marriages that were valid where they were originally authorized, even if the couple lives in a state that does not recognize the validity of the marriage.[1]

FIVE ISSUES WINDSOR DOES NOT SOLVE FOR ARIZONA TAXPAYERS

As Arizona is a state that does not recognize the validity of same-sex marriages,[2] and *Windsor* does not require Arizona to recognize same-sex marriages, the result of *Windsor* and the various agency positions leave open the possibility that where federal statutes rely on state marriage laws or where the state generally provides a parallel treatment to that given to married couples under federal law, Arizona same-sex couples may not fully benefit from the *Windsor* decision. In addition, the reaction of Arizona to the new federal law creates uncertainties about how compliance with Arizona law will affect a same-sex married couple's access to federal tax relief. This article will explore five issues relating to same-sex married couples in Arizona: (1) qualified domestic relations orders ("QDROs"), (2) dividing IRAs in divorce, (3) community property, (4) joint tax filing, and (5) innocent spouse relief.

United States v. Windsor[3]

Edith Windsor and Thea Spyer had been together as a couple in New York City since 1963. The two women later married in Ontario, Canada in 2007. At all times after the marriage until Thea's death in February of 2009, their marriage was deemed valid under New York law.

Thea left her entire estate to Edith who was subsequently appointed as the personal representative of Thea's estate. Edith filed a Form 706, "United States Estate (and Generation Skipping Transfer) Tax Return" and claimed on the form a marital deduction under I.R.C. § 2056(a) for the entire value of the estate passing to Edith as the surviving spouse. That section allows a decedent's estate an estate tax deduction for any property passing to the decedent's surviving spouse. After the Service denied the deduction on the grounds that under Section 3 of the Defense of Marriage Act ("DOMA"), Edith was not a surviving spouse for federal purposes, Edith paid $363,053 in estate taxes from the estate and filed a valid suit against the United States for a refund. In the refund suit, Edith claimed a refund on the grounds that the estate was entitled to the marital deduction because Section 3 of DOMA was unconstitutional.[4]

Section 3 of DOMA amended the federal definition of "marriage" and "spouse" to read as follows:

> *In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.*[5]

After dispensing with certain jurisdictional issues,[6] the Court held that Section 3 of DOMA violates the liberty protected by the United States Constitution's Fifth Amendment Due Process Clause.[7] The Court explained that this deprivation occurred because Section 3's purpose was to treat same-sex marriages unequally under federal law even though those marriages may be equal to all other marriages under the laws of the state where the couple resides.[8]

The *Windsor* decision, however, did not extend to Section 2 of DOMA.[9] Section 2 provides that states may refuse to recognize same-sex marriages performed under the laws of another state or rights or claims arising from those marriages.[10] As a result, Arizona is permitted to continue its non-recognition of same-sex marriages.

QDROs

A QDRO is required to pay any portion of the employee's qualified retirement plan to someone other than the employee during the employee's lifetime (for our purposes the spouse or former spouse) without subjecting the payment to income taxes and penalties.[11] This requirement is also part of the qualifications that allow the plan itself to receive special tax treatment (e.g. tax-exemption) and to meet the requirements of ERISA.[12]

Generally, if a qualified retirement plan that is subject to ERISA (e.g. 401(k)s, pension profit sharing plans, etc.), the plan cannot be split between spouses or paid to the non-employee spouse without a QDRO and without being treated as a taxable distribution from the plan that is potentially subject to an additional 10% income tax penalty.[13]

Among other requirements, a QDRO must be a "domestic relations order" that creates a right in the hands of an alternate payee (for our purposes the spouse or former spouse) to receive all or a portion of the employee's qualified retirement plan.[14] The term "domestic relations order" is defined as "any judgment, decree, or order (including approval of a property settlement agreement) which—(i) relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, and (ii) is made pursuant to a State domestic rela-

tions law (including community property law)."[15]

In Arizona, when a marriage is void, the marriage may be annulled by a family law court.[16] An annulment is not the same as a divorce. In the case of an annulment, the action is based on the premise that the marriage is void or voidable. In the case of a divorce, the action is based on the premise that the marriage is valid.[17] Even in the case of an annulment of a void marriage, however, the Arizona court has authority to divide the property of the couple.[18]

Under Arizona law, all same-sex marriages, even if legally sanctioned where they were performed, are void.[19] Consequently, a same-sex married couple residing in Arizona cannot get a divorce in Arizona, but they can get an annulment. In an annulment, the Arizona court would have authority to hold that a same-sex marriage is void and then order any qualified retirement plans to be split in dividing the property of the couple.

> "a same-sex married couple residing in Arizona cannot get a divorce in Arizona, but they can get an annulment.

Under that circumstance, it is unclear if the resulting order could qualify as a QDRO. To be a QDRO, the order must relate to both "marital property rights" and to a "spouse" or "former spouse." While federal law would clearly recognize the marriage, the annulment and property division would be specifically premised on the idea that no valid marriage ever existed and thus no marital property rights accrued to either party.

The general rule in tax law is that "state law controls in determining the nature of the legal interest which the taxpayer has in property."[20] In *Owen v. Automotive Machinists Pension Trust*, for purposes of interpreting ERISA, the Ninth Circuit held that because the term "marital property rights" is not defined in federal law, the Court was to look to state law to determine those rights.[21] In that case, the couple had lived as unmarried co-habitants for 30 years. The couple argued that a court decree dividing their property was a valid QDRO because under Washington law they were entitled to quasi-marital property for all property they acquired that would have been community property if they had been married. The Ninth Circuit agreed and applied Washington law to determine what constituted marital property rights.[22]

Unlike *Owen*, under Arizona law, absent an enforceable contract to pool funds, there is no quasi-marital property, as there was in *Owen*.[23] Even if a same-sex married couple in Arizona had an enforceable agreement to pool funds, the agreement would likely not create marital property.[24] As a result, federal law under *Windsor* leaves open the possibility that a Federal Court or the Service would look to Arizona law to define marital property rights. In that case the Court or the Service may conclude that a property division in an annulment does not qualify as a division of marital property, even if the couple had an enforceable agreement to pool funds. The resulting order would also not qualify as a QDRO.

Individual Retirement Arrangements

Transfers of interests in individual retirement arrangements (IRAs), which include individual retirement accounts and individual retirement annuities, generally are treated as taxable distributions from the IRA that are subject to a 10% tax penalty.[25] One exception to that rule exempts transfers from an IRA to a spouse or former spouse from that treatment if the transfer is made "under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2)."[26] I.R.C. § 71(b)(2)(A), which deals with the tax treatment of alimony payments, defines a "divorce or separation instrument" as a "decree of divorce or separate maintenance or a written instrument incident to such a decree."[27]

In interpreting § 71 in the alimony context, on three occasions the United States Tax Court has held that a divorce and an annulment decree are viewed as the same.[28] In addition, the Service has taken the same position with respect to alimony payments.[29] The reasoning for

the Tax Court decisions and the Service's position was that if the decree has the same effect of ordering support payments, a decree for annulment or for divorce should be the same. There are no cases or Service positions on whether this same reasoning applies in the context of dividing IRAs.

By comparison, temporary regulations spell out that interests in non-qualified annuities can be split tax-free in an order of annulment. Generally, interests in non-qualified annuities cannot be transferred for less than adequate consideration without accelerating all of the deferred income in the contract to the contract owner and subjecting the accelerated income to a 10% tax penalty.[30] The exception to this income acceleration rule is a transfer of the contract between spouses or incident to a divorce, under the principals of I.R.C. § 1041.[31] Under that section, a transfer is "incident to a divorce" if the transfer "(1) occurs within 1 year after the date on which the marriage ceases; or (2) is related to the cessation of the marriage."[32] This allows for transfers to be exempted from income acceleration if made within 1 year of the cessation of a marriage, even if they are not related to the cessation of the marriage.[33] The § 1041 temporary regulations clarify that an annulment of a marriage that was void *ab initio* under state law is treated as a divorce under that section.[34]

As discussed above, there is no divorce for a void marriage in Arizona. In addition there is no provision for alimony in an Arizona annulment.[35] It is not clear that an Arizona annulment that cannot award alimony would be treated the same as a § 71 "divorce or separation instrument" that does award alimony. There is also no guidance on how the Ninth Circuit would interpret § 71 as it relates to IRAs. If the Tax Court can treat an annulment as a divorce in the alimony context, it seems logical that the same rule would apply in the IRA context. Despite that logic, there are no clear cases or Service rulings applying the § 71 principals to the IRA context. While the non-qualified annuity rules would seem to shed light, the Service has privately ruled that the IRA rules are not governed by the non-qualified annuity rules.[36]

Community Property

Holding community property can be a benefit to a surviving spouse. Among those benefits, half of the value of the property will not be included in a deceased spouse's gross estate, which reduces the decedent's gross estate and potentially the decedent's estate tax liability.[37] Also, the surviving spouse is entitled to a new basis for the entire value of the property acquired from the decedent.[38] Assuming the date of death value of the assets exceeds the decedent's basis, this can result in significant tax savings. The basis the surviving spouse receives is a new basis for the surviving spouse for most purposes, but the surviving spouse is allowed to take a holding period in the property of more than 1 year, even if the surviving spouse actually held the property for less than 1 year.[39] As a consequence, capital assets that would have been taxed at higher short-term capital gains rates if sold immediately before the decedent's death can be sold for lower long-term capital gains rates immediately after the decedent's death.[40] In addition, the surviving spouse gets a new basis for depreciation purposes. This means that if the property had been depreciated on an accelerated basis, any depreciation recapture amount, which would otherwise be taxed as ordinary income, is eliminated and the surviving spouse gets to start the depreciation process and recapture accumulation anew.[41]

These generous benefits only accrue to a surviving spouse holding community property. A joint tenant with the decedent only gets a new basis as to the portion of the tenancy that is included in the decedent's gross estate.[42] If the joint tenants are spouses and they are the only joint tenants, then one-half of the value of the joint tenancy property is includible in the decedent's estate and subject to a new basis at death.[43]

State law determines if property is community property.[44] In Arizona, a couple that is unmarried does not acquire community property.[45] As a result, the best that a same-sex married couple in Arizona could do is to hold property as joint tenants with rights of survivorship, as the only joint tenants. In that case, for both estate tax and income tax purposes half of the property would be deemed in the gross estate of the decedent spouse and acquired from the decedent spouse. *Windsor* does not change this outcome.

Joint Tax Returns

Under the Service's interpretation of *Windsor*, same-sex married couples may now file joint tax returns.[46] Same-sex married couples are also allowed to amend past returns to claim the status of "married filing jointly" and to adjust for other taxes imposed on unmarried taxpayers[47] and claim a refund (to the extent the refund limitations period is still open).[48] These options exist even for Arizona same-sex couples who were married in a state that authorizes same-sex marriages.

Arizona income tax uses the taxpayer's federal adjusted gross income as the starting point to determining the taxpayer's Arizona income tax liability.[49] Arizona married couples are allowed to file a joint return.[50] As same-sex marriages are not recognized in Arizona, no same-sex couple that can validly file a joint federal income tax return is allowed to file a joint Arizona income tax return.

In recognition of this issue, the Arizona Department of Revenue recently released a new Schedule S to the Arizona Form 140. The schedule requires same-sex married couples who filed a joint federal income tax return to report what portion of the tax items comprising their federal adjusted gross income is attributable to each spouse, respectively. The spouses must fill out one Schedule S and attach a copy of the schedule to each spouse's Arizona income tax return (to the extent one is required to be filed).[51] If the couple filed separate federal income tax returns, then Schedule S is inapplicable. In addition, if the couple filing a joint federal income tax return itemizing deductions, and the spouses wish to itemize deductions on their Arizona income tax returns, each spouse must fill out a Federal Form 1040, Schedule A as if they had filed a separate federal return and attach that schedule to their separate Arizona income tax returns.[52]

The Service's position is that where a married couple files a joint return in one year and then has the marriage annulled in a subsequent year, that because the marriage is deemed void *ab initio* by the annulment the taxpayers are required to file amended returns and file separately (as unmarried) in the jointly filed year.[53] Since same-sex marriages are void in Arizona, a same-sex married couple in Arizona may have to amend all jointly filed returns upon getting an annulment. This would likely apply to all jointly filed returns or elections, like an election under I.R.C. § 2513 to split gifts on a spouse's gift tax return. This would likely only apply to returns for which the assessment limitations period is still running.

Thus, while *Windsor* makes joint income tax returns available for federal purposes, where an Arizona same-sex married couple files a joint federal income tax return that couple still may not file a joint Arizona income tax return. In addition, if a same-sex married couple files joint federal returns or makes other spousal tax elections and then gets an annulment in Arizona, the couple may have to amend all prior returns that still have open assessment limitations periods.

Innocent Spouse Relief

For both Arizona and federal law purposes, generally each joint filer is jointly and severally liable for the taxes due on a joint return.[54] Since Arizona same-sex married couples cannot file joint Arizona income tax returns, they have no basis or need to seek relief from joint liability in Arizona. In the parallel universe of federal tax, however, spouses in those couples may seek relief from federal income tax liabilities on joint returns. It is unclear if the filing a Schedule S with one's Arizona income tax return will make it more difficult in certain cases to get federal relief.

Federal law grants four main ways for a joint return filer to escape the application of joint and several liability: (1) § 66(c) relief from community property, (2) § 6015(b) innocent spouse relief, (3) § 6015(c) tax liability apportionment among divorced joint filers, and (4) § 6015(f) equitable relief. Only § 6015(b) innocent spouse relief and § 6015(f) equitable relief, however, are relevant for purposes of this article.

In order to qualify for innocent spouse relief, a taxpayer must show, among other things, that imposing the tax liability on the taxpayer would be inequitable under the facts and circumstances.[55] If a spouse cannot qualify for relief under §§ 6015(b) or (c), he or she may get equitable relief from joint liability if,

among other things, the spouse did not know or have reason to know about an understatement or underpayment of taxes.[56]

The facts and circumstances the Service will consider in innocent spouse relief includes that the spouse did not know or have reason to know about an understatement of tax on the joint return.[57] Among the factors the Service will consider in determining if the spouse knew or should have known about the understatement is "whether the requesting spouse failed to inquire, at or before the time the return was signed, about items on the return or omitted from the return that a reasonable person would question."[58] Deliberately avoiding learning about an item also weighs in favor of the spouse having the requisite knowledge of the understatement.[59]

It is possible that filing an Arizona Schedule S could hurt same-sex spouses seeking innocent spouse and equitable relief. Each spouse will have to list his or her items of income on the Schedule S next to the other spouse's items. It may be harder for a spouse seeking relief to claim he or she did not know about the other spouse's tax items when they will be clearly itemized on the schedule. At a minimum, the Service could reasonably take the position that the schedule puts each spouse on notice of the other spouse's claimed tax items. Unlike on a joint return, where it is not readily clear which spouse is the source of those items, Schedule S does not leave any doubt. In some circumstances, Schedule S may have no bearing on this factor. For example, if a spouse conceals taxable income from the spouse requesting relief, the concealed income would not likely be attributed to the requesting spouse.[60] Nonetheless, it remains to be seen whether Schedule S will be detrimental to those seeking innocent spouse or equitable relief.

Conclusion

While *Windsor* answers many federal tax questions, for Arizona same-sex married couples, some issues remain undetermined. This results from the reliance of federal law, in certain cases, on state law and on the application of parallel state and federal tax laws on those couples. As the new federal law is implemented, the Service will likely provide answers formally or informally to these and other issues. In the meantime, practitioners should analyze married same-sex client's situations individually to determine that the interplay of the new federal law and existing Arizona law does not create special problems. tln

Endnotes

1. *See* Rev. Rul. 2013-17; IRS "Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law," **http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples**; and Department of Labor, Technical Release No. 2013-04, **http://www.dol.gov/ebsa/newsroom/tr13-04.html**.
2. Ariz. Const. Art. 30; A.R.S. §§ 25-101(C), 25-112.
3. 133 S.Ct. 2675 (2013).
4. 133 S.Ct. at 2683.
5. 1 U.S.C. §7.
6. See 133 S.Ct. at 2684–89.
7. 133 S.Ct. at 2695.
8. 133 S.Ct at 2693–94.
9. 133 S.Ct. at 2682.
10. 28 U.S.C. § 1783C.
11. I.R.C. §§ 72(t)(2)(C), 402(e)(1).
12. I.R.C. § 401(a)(13)(B); 29 U.S.C. § 1056(d)(3)(A).
13. I.R.C. §§ 72(t)(2)(C), 402(e)(1).
14. I.R.C. § 414(p)(1)(A); 29 U.S.C. § 1056(d)(3)(B)(i).
15. I.R.C. § 414(p)(1)(B); 29 U.S.C. § 1056(d)(3)(B)(ii).
16. A.R.S. § 25-301.
17. *See Means v. Indus. Comm'n*, 110 Ariz. 72, 75, 515 P.2d 29, 32 (1973).
18. A.R.S. § 25-302(B).
19. *See* A.R.S. § 25-101(C).
20. *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985) (quoting *Aquilino v. United States*, 363 U.S. 509, 513 (1960)).
21. 551 F.3d 1138, 1144 (9th Cir. 2009).
22. *Owen*, 551 F.3d at 1146.
23. *Smith v. Mangum*, 155 Ariz. 448, 450, 747 P.2d 609, 611 (Ct. App. 1987).
24. *Cook v. Cook*, 142 Ariz. 573, 577, 691 P.2d 664, 668 (Ct. App. 1984).
25. I.R.C. § 72(t)(1); Treas. Reg. § 1.408-4(a)(2).
26. I.R.C. § 408(d)(6).
27. I.R.C. §§ 71(b)(2)(A), 408(d)(6).
28. *See Newburger v. Comm'r*, 61 T.C. 457, 460 (1974); *Reisman v. Comm'r*, 49 T.C. 570, 572 (1968); *Laster v. Comm'r*, 48 T.C. 178, 189 (1967); Reighley v. Comm'r, 17 T.C. 344, 353 (1951).
29. Rev. Rul. 59-130.
30. I.R.C. §§ 72(e)(4)(C)(i), 72(q)(1).
31. I.R.C. § 72(e)(4)(C)(ii).
32. I.R.C. § 1041(c).
33. Treas. Reg. § 1.1041-1T(b), Q&A 6.
34. Treas. Reg. § 1.1041-1T(b), Q&A 8.
35. *See* A.R.S. §§ 25-302(B), 25-312(4).
36. *See* PLR 8820086, 9422060.
37. *See* I.R.C. § 2031(a).
38. I.R.C. § 1014(b)(6); Treas. Reg. § 1.1014-2(a)(5).
39. *See* I.R.C. § 1223(9); Treas. Reg. § 1.1223(j).
40. Currently the highest short-term capital gains rate is 39.6% and the highest long-term capital gains rate is 20%, not taking the Medicare surtax into account.
41. *See* Treas. Reg. §§ 1.1250-3(b)(2) & -3(b)(3), ex. 1.
42. *See* I.R.C. §§ 1014(b)(1); 2040(a).
43. *See* I.R.C. §§ 1014(b)(1); 2040(b).
44. *Nat'l Bank of Commerce*, 472 U.S. at 722; Rev. Rul. 87-98.
45. *Cook*, 142 Ariz. at 577, 691 P.2d at 668.
46. *See* I.R.C. § 6013(a); Rev. Rul. 2013-17; IRS "Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law," **http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples**.
47. E.g. the tax imposed on employer-provided health care insurance for an unmarried person's partner that is included in the employee's compensation.
48. IRS "Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law," **http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples**.
49. A.R.S. § 43-301.
50. A.R.S. § 43-309.
51. *See* 2012 Arizona Individual Income Tax Filing Requirements for Same-Sex Couples, **http://www.azdor.gov/LinkClick.aspx?fileticket=mDpbGMu7LmU%3d&tabid=257&mid=878**.
52. *Id.*
53. Rev. Rul. 76-255.
54. A.R.S. § 43-562; I.R.C. § 6013(d)(3).
55. I.R.C. § 6015(b)(1)(D).
56. I.R.C. § 6015(f); Rev. Proc. 2013-34.
57. Treas. Reg. § 1.6015-2(c).
58. *Id.*
59. *See* Treas. Reg. §§ 1.6015-2(c), 1.6015-3(c)(2)(iv).
60. *See* Treas. Reg. § 1.6015-2(e)(2), ex.; see also Rev. Proc. 2013-34, § 4.03(2)(c)(i)(A) (weighing in the requesting spouse's favor facts and circumstances that show the other spouse maintained control of the couple's finances and restricted the requesting spouse's access to financial information, even if the requesting spouse knew or reasonably should have known about an understatement of tax).

Summary of 2013 Arizona Tax Legislation

This article briefly summarizes recent substantive changes to Arizona's tax laws. The bills addressed herein were approved by both houses of Arizona's Legislature and signed by Governor Brewer. Except as noted below, most of the bills were effective on September 13, 2013.

To limit the size of this article, the descriptions of these bills are brief and not intended to be comprehensive. If you believe that one or more of the following bills may impact the amount of tax that you, your clients, or the company that you work for must pay, you should carefully review the bill and/or contact a state and local tax professional for assistance.

Income Tax Legislation

SB 1168: Internal Revenue Code Conformity. Laws 2013, Chapter 65.

Provides for retroactive conformity to most provisions in the Internal Revenue Code in effect on January 3, 2013, including most of the provisions of the FAA Modernization and Reform Act (P.L. 112-95), and all of the provisions of the Moving Ahead for Progress in the 21st Century Act (P.L. 112-141) and the American Taxpayer Relief Act of 2012 (P.L. 112-240) – some of which are retroactive to one or more previous tax years. However, Arizona did not conform to the retroactive provisions of the FAA Modernization and Reform Act (P.L. 112-95) for tax years 2002 through 2011. Instead, the Legislature created a new, refundable credit to be claimed on original, timely filed 2013 individual returns by taxpayers who would have received a refund of Arizona income tax if Arizona conformed to the retroactive provisions. The credit is equal to the reduction in Arizona taxes that would have occurred for tax years 2002 through 2011 if Arizona conformed to the federal law. Additions and subtractions created in prior years when Arizona did not fully conform to I.R.C. changes for issues such as bonus depreciation and increased I.R.C. § 179 expenses are still in place, except as explained under the summary for HB 2531 below.

SB 1179: Ignition Interlock Devices; TPT Exemption. Laws 2013, Chapter 236.

Increases the amount that may be subtracted from Arizona gross income, retroactive to January 1, 2013, for contributions to colleges savings plans established pursuant to § 529 of the IRC to the extent that the contributions were not deducted when computing federal adjusted

gross income. For single individuals and heads of households, the amount increased from $750 to $2,000. For married couples filing jointly, the amount increased from $1,500 to $4,000. Permits individuals to claim the $200/$400 credit for contributions to qualifying charitable organizations even if they do not itemize their deductions. Allows qualifying universities with multistate income the option to apportion income from certain types of tuition and fees based on the destination of their customers (market approach) rather than to the state where the greater portion of their income producing activity occurred (income approach) based on costs of performance. For universities that make this election, the market sales approach will be phased in as follows: (1) for tax year 2014: 85% market, 15% income, (2) for tax year 2015: 90% market, 10% income, (3) for tax year 2016: 95% market, 5% income, and (4) for tax year 2017: 100% market. (Also changes Arizona's sales and property tax laws as summarized below.)

SB 1313: Tax Corrections. Laws 2013, Chapter 114.

Makes numerous technical corrections, and even some substantive changes, to Arizona's tax laws. Income tax provisions include clarifications and minor changes to Arizona's individual and/or corporate income tax credits for the following: increased research activities, installing commercial or industrial solar energy devices, locating or expanding qualified renewable energy operations in the state, and investing in or adding qualifying net new full-time employment positions at qualifying manufacturing, headquarters, or research facilities. For example, this bill requires the Arizona Commerce Authority to establish a preapproval process for individuals and companies that claim commercial solar energy income tax credits and eliminates statutory references to Arizona's credit for motion picture production costs that expired at the end of 2010. (Also changes Arizona's property and other tax laws as summarized below.)

SB 1417: Reviser's Technical Corrections; 2013. Laws 2013, Chapter 168.

This technical correction bill repeals a duplicative 2012 amendment to the individual and corporate income tax credits for increased research activities retroactive to the August 2, 2012 effective date for the 2012 amendment.

SB 1447: ADE; School Finance Revisions. Laws 2013, Chapter 251.

Changes the name of the fund taxpayers may contribute any portion of their Arizona income tax refund to from a contribution for "state aid to public schools" to a contribution for "funding solutions teams assigned to schools."

HB 2009: 2013-2014; Revenue; Budget Reconciliation. Laws 2013, Chapter 9.

Doubles the maximum individual income tax credit taxpayers may claim, from $200/$400 to $400/$800, for contributions to qualifying charitable organizations if the organization is a qualifying foster care charitable organization. Retroactive to January 1, 2013. (Also changes Arizona's sales tax laws as summarized below.)

HB 2531: Income Tax; Instant Depreciation. Laws 2013, Chapter 256.

Provides that, effective January 1, 2013, individuals and corporations who claim deductions under I.R.C. § 179 are no longer required to add back amounts in excess of $25,000. Thus, for tax year 2013, subject to existing limitations, individuals and corporations may claim § 179 deductions for up to $500,000 on both their federal and Arizona income tax returns.

Transaction Privilege ("Sales") and Use Tax Legislation

The following changes are applicable to Arizona's sales and use tax laws and to the county excise taxes that "piggy back" Arizona's sales taxes. Unless otherwise specified below, Arizona municipalities have not adopted these changes. However, Arizona municipalities often do adopt changes to their municipal tax codes that parallel changes to the state's sales and use tax laws.

SB 1179: Ignition Interlock Devices; TPT Exemption. Laws 2013, Chapter 236.

Clarifies, retroactive to January 1, 2002, that qualified destination management companies are not subject to sales tax on their proceeds from contracts to provide destination management services. Provides an exemption from Arizona's state and local personal property rental taxes, retroactive to September 1, 2004, but with strict limits on refunds, for proceeds from leasing or renting certified ignition interlock devices. Updates the definition of "eligible grocery business" for purposes of the exemption from Arizona's retail sales tax for sales of qualifying food items. Eliminates the requirement for the Department to annually publish lists of tax exempt food items and repeals the statute granting the Department permission to issue administrative rulings regarding the taxability of food items. Prohibits the Department from classifying medicines or dietary supplements, such as vitamins and protein supplements, as tax exempt food. Clarifies that all ready-to-drink, nonalcoholic beverages intended for human consumption that are contained in closed or sealed bottles, cans, or cartons are tax exempt food items. (Also changes Arizona's income tax laws as summarized above and Arizona's property tax laws as summarized below.)

SB 1286: Nursing Facility Provider Assessments. Laws 2013, Chapter 37E.

Excludes Arizona Veterans' Homes from the "quality assessment" (tax) on health care items and services provided by nursing facilities. The assessment was enacted during the 2012 legislative session in order to obtain additional federal funding for Arizona's Medicaid program, the Arizona Health Care Cost Containment System, and is administered by the Department using most of the same rules and procedures that govern the administration of sales taxes. Retroactive to October 1, 2012.

HB 2009: 2013-2014; Revenue; Budget Reconciliation. Laws 2013, Chapter 9.

Provides that, effective September 1, 2013, owners, operators, and qualified colocation tenants of certified computer data centers are not subject to state or local sales or use tax on qualifying equipment purchases for ten years (twenty years for "sustainable development projects"). Tax relief granted under this program may be recaptured from the owner or operator of the data center if minimum investment requirements are not met on or before the fifth anniversary of certification. Grants the Department and the Arizona Commerce Authority a one-year exemption from the Administrative Procedure Act for purposes of implementing these provisions. (Also changes Arizona's income tax laws as summarized above.)

HB 2111: Transaction Privilege Tax Changes. Laws 2013, Chapter 255.

Implements some of the changes recommended by Governor Brewer's Transaction Privilege Tax Simplification Task Force. The provisions of this bill, all of which will go into effect on January 1, 2015, may be categorized as follows:

Administrative Changes and General Provisions:

(1) requires the Department to administer an online portal as a single point for taxpayers to obtain all state and local sales tax licenses, file and pay all state and local sales, use, severance, rental occupancy, and jet fuel excise taxes, (2) prohibits municipalities from conducting audits for such taxes unless the taxpayer is only engaged in business in the municipality conducting the audit or the municipality is authorized by the Department to conduct the audit, (3) specifies that all audits of such taxes must be conducted in accordance with procedures outlined in the Department's audit manual by auditors trained in such procedures, (4) requires the Department to issue any assessments resulting from such audits for all jurisdictions in a single notice to the taxpayer, (5) provides that any appeals of such assessments must be directed to the Department, (6) requires the Department to notify all affected municipalities before entering into any compromise, closing, settlement, or other agreement with a taxpayer related to taxes levied by the municipality, (7) authorizes the Department to adopt emergency rules as necessary to implement the changes required by this bill, and (8) explains that, with this bill, the Legislature intended to simplify the administration of Arizona's transaction privilege taxes in order to promote voluntary compliance.

Retail Sales Tax Provisions:

(1) provides that retail sales taxes are sourced to the seller's business location if the seller receives the order at a business location in Arizona and, otherwise, to the purchaser's location, (2) changes the statutory language of Arizona's retail sales tax exemption for sales to nonresidents of the state for use outside the state if the vendor ships or delivers the product outside the state so that it only applies to sales of motor vehicles, and (3) eliminates the statutory language of Arizona's retail sales tax exemption for sales of tangible personal property that is shipped or delivered directly to a destination outside of the U.S. for use in that foreign country. (See also the retail sales tax provisions relating to construction contractors summarized below.)

Personal Property Rental Tax Provision:

Provides that Arizona's sales tax on proceeds from leasing or renting personal property shall be sourced to the lessor's business location if the lessor has a business location in Arizona and, otherwise, to the lessee's address.

Provisions Relating to Construction Contractors:

(1) clarifies that machinery and equipment or other tangible personal property used by a contractor in the performance of a contract normally is subject to retail sales or use tax, (2) provides a deduction from Arizona's state prime contracting tax and municipal construction contracting taxes for proceeds from contracts with owners of real property that only require the contractor to maintain, repair, or replace existing property, (3) requires such contractors who only maintain, repair, or replace existing property to pay sales tax on tangible personal property used on contracting jobs that are not subject to sales tax, (4) specifies that construction contracts that include design phase services or professional services must separately state the terms, conditions, and prices for such services in writing in order to qualify for the deduction from Arizona's prime contracting tax, but provides that such terms, conditions, and prices do not have to be in contracts separate from the construction contracts, (5) officially eliminates Arizona's owner builder tax (but not municipal taxes on owner-builders), and

(6) states that, with this bill, the Legislature did not intend to provide an exemption for contractors engaged in the modification of real property as part of a major remodel project.

County Transportation Excise Tax Provision: Alters the calculation of the maximum tax rate for county transportation excise taxes on sales of jet fuel.

HB 2259: Orthodontic Devices; Transaction Privilege Tax. Laws 2013, Chapter 120.

Clarifies that orthodontic devices dispensed by licensed dental professionals to their patients are not subject to state or local sales tax. Retroactive to October 1, 2007.

HB 2267: Public Consignment Auction Dealer; Requirements. Laws 2013, Chapter 40.

Requires public consignment auction dealers to notify both the Department and the Arizona Department of Transportation within fifteen days of selling a motor vehicle and to begin submitting exemption certificates to the Department when selling motor vehicles to nonresidents for use outside the state in addition to retaining such certificates in case of audit.

HB 2324: Commercial Lease Exemption. Laws 2013, Chapter 27.

Expands existing exemptions from state and local sales taxes for leases of real property between affiliated corporations to apply to leases of real property between affiliated "companies, businesses, persons or reciprocol insurers." For purposes of these exemptions: (1) "affiliated" means the lessor holds a controlling interest in the lessee, the lessee holds a controlling interest in the lessor, an affiliated entity holds a controlling interest in both the lessor and the lessee, or an unrelated party holds a controlling interest in both the lessor and lessee, and (2) "controlling interest" means direct or indirect ownership of at least eighty percent of the voting shares of a corporation or of the interests in a company, business, or person other than a corporation.

HB 2336: Taxation; Retail Classification; Cash Equivalents. Laws 2013, Chapter 233.

Clarifies that the sale of "cash equivalents," like gift cards, gift certificates, traveler's checks, money orders, etc. are not subject to sales tax when purchased, but that prepaid calling cards are still subject to sales tax when purchased. Retroactive to January 1, 1999 with strict limits on refund claims.

HB 2535: Independent Functional Utility. Laws 2013, Chapter 153.

Provides that contracts to install, assemble, repair, or maintain qualifying tax exempt machinery and equipment, or other personal property, that has independent functional utility are not subject to Arizona's prime contracting tax or municipal construction contracting taxes. Explains that it is the Legislature's intent that the benefit of qualifying sales and use tax deductions should not be diminished by contracting activities. Retroactive to July 1, 1997, with strict limits on refund claims.

Property Tax Legislation

SB 1169: Proposition 117; Conformity. Laws 2013, Chapter 66.

Changes terminology used in Arizona property tax statutes to conform to the constitutional amendments required by Proposition 117, which limits valuation increases on locally assessed real property to five percent (5%) or less beginning in tax year 2015 and establishes a single limited property value as the basis for calculating all property taxes. Effective dates for some provisions of this bill are tax year 2014 while other provisions are not effective until tax year 2015.

SB 1179: Ignition Interlock Devices; TPT Exemption. Laws 2013, Chapter 236.

Extends class 6 property tax status, with its five percent (5%) assessment ratio, through December 31, 2023 for property used specifically and solely to manufacture qualifying biodiesel fuel or qualifying motor vehicle biofuel. (Also changes Arizona's income and sales tax laws as summarized above.)

SB 1313: Tax Corrections. Laws 2013, Chapter 114.

Makes numerous technical corrections, and even some substantive changes, to Arizona's tax laws. Property tax provisions include clarifications relating to requirements for class 6 properties used as headquarters or in manufacturing operations for qualified renewable energy companies. (Also changes Arizona's income tax laws as summarized above and Arizona's other tax laws as summarized below.)

HB 2344: Property Tax Penalty Waiver. Laws 2013, Chapter 9.

Allows county treasurers, in consultation with county boards of supervisors, to waive penalties imposed on homeowners who fail to respond to requests for information concerning whether their property is used as their qualifying primary residence or as the residence of a qualifying family member. Retroactive to July 1, 2012, but only in effect until June 30, 2014.

HB 2346: Valuation; Rural Electric Cooperatives. Laws 2013, Chapter 226.

Provides a special method for valuing property owned by member-owned nonprofit electric distribution cooperative corporations. Effective for valuation years beginning January 1, 2014.

Other Tax and Tax-Related Legislation

SB 1286: Nursing Facility Provider Assessments. Laws 2013, Chapter 37E.

Excludes Arizona Veterans' Homes from the "quality assessment" (tax) on health care items and services provided by nursing facilities. The assessment was enacted during the 2012 legislative session in order to obtain additional federal funding for Arizona's Medicaid program, the Arizona Health Care Cost Containment System, and is administered by the Department using most of the same rules and procedures that govern the administration of sales taxes. Retroactive to October 1, 2012.

SB 1312: Tobacco Product Manufacturers; Cigarette Machines. Laws 2013, Chapter 222.

Authorizes the Department to seize illegal tobacco product rolling vending machines and all related supplies and tobacco products, which must be forfeited to the state. Provides that such forfeited tobacco products, and any tobacco products that are illegally ordered, purchased, or transported, shall be deemed contraband and destroyed.

SB 1313: Tax Corrections. Laws 2013, Chapter 114.

Makes numerous technical corrections, and even some substantive changes, to Arizona's tax laws, including clarifications and minor changes to the "quality assessment" (tax) levied on health care items and services provided by nursing facilities. For example, the bill eliminates the penalty that the Department was required to assess on nursing facilities that failed to timely pay the full amount assessed. (Also changes Arizona's income and property tax laws as summarized above.)

HB 2111: Transaction Privilege Tax Changes. Laws 2013, Chapter 255.

Implements some of the changes recommended by Governor Brewer's Transaction Privilege Tax Simplification Task Force. As described in connection with the summary of sales tax changes implemented by this bill, this bill also affects other miscellaneous taxes. For example, it: (1) requires the Department to administer an online portal as a single point for taxpayers to file and pay all state and local severance, rental occupancy, and jet fuel excise taxes, (2) prohibits municipalities from conducting audits for such taxes unless the taxpayer is only engaged in business in the municipality conducting the audit or the municipality is authorized by the Department to conduct the audit, (3) specifies that all audits of such taxes must be conducted in accordance with procedures outlined in the Department's audit manual by auditors trained in such procedures and issued by the Department for all jurisdictions in a single notice to the taxpayer, (4) provides that any appeals of such assessments must be directed to the Department, (5) requires the Department to notify all affected municipalities before entering into any compromise, closing, settlement, or other agreement with a taxpayer related to taxes levied by the municipality, (6) alters the calculation of the maximum tax rate for county transportation excise taxes on sales of jet fuel, and (7) authorizes the Department to adopt emergency rules as necessary to implement the changes required by this bill. All changes are effective January 1, 2015. (Also changes Arizona's sales tax laws as summarized above.)