Arizona Income Tax Update

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Updated Composite Return Filing Ruling Issued

Individual Income Tax Ruling, ITR 16-2, 9/13/16
The Department of Revenue issued an updated ruling (ITR 16-2) for filing composite individual income tax returns, superseding ITR 13-2.

Partnerships and S corporations are authorized to file a composite return for certain nonresident shareholders/partners in lieu of those individuals filing their own nonresident returns.

Per the ruling, the following conditions must be met to file a composite return:

- Members included in the composite return must be nonresident individuals of the state for the full taxable year. A distribution to a disregarded LLC or a Grantor Trust by an S corporation or a partnership is treated as a distribution to the owner of the disregarded LLC or the Grantor Trust2. If the owner of the disregarded LLC or the Grantor Trust meets all of the other requirements to be a member of the composite return, the owner may be included.
- Members included in the composite return must have no income (including spouse's) from sources within the state other than his or her distributive share of S corporation or partnership income allocable to Arizona. Partners of two or more affiliated partnerships that report the income from those partnerships to Arizona on one composite return will not be considered to have Arizona income from more than one source.
- Deceased members may not be included in the composite return.
- All members included in the composite return must have the same tax year for income tax purposes.

The return must include an affidavit from each shareholder/member included in the return stating the above items are true for that shareholder/member. As well, a Power of Attorney authorizing the entity to file the return must be executed by each shareholder/member included in the return.

Some other limitations for a composite return are:

- Only the standard deduction in lieu of itemized deductions will be allowed.
- No tax credits will be allowed.
- No net operating losses will be allowed.
- A composite return filed by an entity may be on behalf of some or all of its members which are eligible to participate. However, a composite return cannot be filed with fewer than ten participating members.
- Any refund of overpayment of income taxes made on a composite basis must be remitted to the entity for distribution to the members.
- No person who is required to make payments of Arizona estimated tax may be a member of the composite return. An individual who participates in the filing of a composite return cannot make voluntary Arizona estimated income tax payments. The entity filing the composite return may make voluntary estimated payments on a composite basis on behalf of the participating members. Such estimated income tax

payments must be remitted with Arizona Form 140ES, under the filing entity's employer identification number.
- A composite return may not be changed or corrected except by an amended composite return filed by the entity.

The notice goes on to provide the following for filing the form:

- The form for filing a composite return will be the Arizona Nonresident Personal Income Tax Return, Form 140NR.
- The Residency Status box, Composite Return, on page 1 must be checked.
- Note: To amend the composite return use the Arizona Individual Amended Income Tax Return, Form 140X. For an amended return, filed for a taxable year ending on or before 12/31/2014, the return must be labeled, "Composite Return" on top of page 1 of the form. For an amended return, filed for a taxable year beginning after 12/31/2014, the Residency Status box, Composite, on page 1 must be checked.
- The taxpayer's name and address shown on the front of Form 140NR will be the entity's name and address.
- The taxpayer's identifying number shown on the front of Form 140NR will be the entity's employer identification number. In the case of two or more affiliated partnerships reporting income from the members on one composite return, the taxpayer's name, address, and employer identification number shown on the front of Form 140NR will be the primary partnership's name address and identifying number. The name, address, and identifying number of the remaining affiliated partnerships must be reported on an attached schedule.
- A comprehensive schedule must be attached showing the names, addresses, social security numbers, and mathematical calculations for the Arizona income ratio (percentage), the standard deduction, and the Arizona tax liability for each nonresident partner or shareholder included in the composite return. In the case of two or more affiliated partnerships reporting income from the members on one composite return, a schedule must be attached showing the separately computed income from each partnership for each partner and the computation of the member's tax liability which shall be computed on the total of the member's income from those partnerships less allowable subtractions and exemptions.
- The names, addresses, and social security numbers of any excluded members must be disclosed on the schedule.
- The composite return must be signed by the partners or corporate officers authorized to sign the partnership return or S corporation income tax return.

The computation of each member’s deductions, exemptions and liability is computed as follows:

- The Arizona income ratio of each member's total income in relation to the federal income must first be computed. This is done by dividing the amount shown on the member's Arizona nonresident Schedule K-1 by the federal adjusted gross income shown on the member's individual federal income tax return. Each member's income ratio must be rounded to three decimal places and cannot be greater than 1.000.
- The standard deduction for each member shall not exceed the maximum amount allowable for that member for the specific tax year being filed. The number of

dependents, age sixty-five or over, blind and personal exemptions being claimed are to be multiplied by the amount allowable for the year being filed. Both the standard deduction and exemption amounts are then to be multiplied by the Arizona income ratio computed above.

- The taxable income for each participating member shall be computed by beginning with the Arizona income shown on the member's nonresident Schedule K-1. From this amount, the amounts computed in items 1 and 2 above shall be deducted. The taxable income for each participating member reporting income from two or more affiliated partnerships shall be computed by beginning with the total of the Arizona income shown on the member's nonresident Schedule K-1s from each partnership.
- Each member's tax liability shall be computed separately based on the separate taxable income using the appropriate tax table for the tax year involved.
- The aggregate amounts for income, exemptions, deductions, and liabilities for all of the participating members are to be reported on the return.

But the ruling goes on to note:

> However, members who are participating in the filing of a composite return may elect to waive their right to claim all allowable exemptions, subtractions, and deductions. If this is done, the tax is to be calculated directly upon the member's pro rata share of the entity income at the appropriate individual tax rate for the year. A participating member making this election must sign a waiver relinquishing the right to claim all of the exemptions, subtractions, and deductions allowed on the composite return. The waivers must be maintained in the S corporation or partnership files subject to review by the Department of Revenue.

The state income liability is not to be paid by the partnership or S corporation, but instead must be paid by the member directly to the state, or remittance to the S corporation or partnership or by a charge against a shareholder's or partner's loan account.

The composite return are due on the 15th day of the fourth month following the close of the year. Extensions of time must be requested on a composite basis, and regardless of whether a federal extension is requested a separate Arizona Form 204 must be filed.

Composite returns cannot be filed electronically. The S corporation and/or partnership must still file its own entity return.

The ruling also notes:

> A Grantor Trust whose nonresident owner/grantor is included in a composite return is not relieved from the requirement to file its own state entity return for the tax year. The Grantor Trust must file Arizona Form 141AZ.

Depreciation Procedures Updated by Department of Revenue

Individual Income Tax Procedure, ITP 16-2, 9/13/16

With the changes made to Arizona's treatment of bonus depreciation, the Department of Revenue has issued an Individual Income Tax Procedure to explain how individuals should make the adjustments needed on their returns for bonus depreciation assets (ITP 16-2) superseding the prior procedure ITP 15-1.

The procedure notes that Arizona taxpayers must add back federal depreciation and then take a deduction for the revised Arizona depreciation. As the procedure notes:

> Once the taxpayer makes the required addition to income, the taxpayer must compute depreciation for Arizona income tax purposes. The taxpayer will then take a subtraction from income on the Arizona income tax return for the amount of depreciation computed on the Arizona basis. The amount of depreciation the taxpayer may subtract on the Arizona return will depend on when the asset was placed in service.

Similarly, the taxpayer must make an adjustment when the asset is disposed of.

Due to law changes the ruling is broken down by date ranges. The first option is for assets placed in service beginning before January 1, 2013.

As the ruling notes:

> For taxable years that began before 2013 (taxable years 2012 or earlier), Arizona did not allow bonus depreciation. Therefore a taxpayer that deducted bonus depreciation for federal income tax purposes was required to make an addition to income for the total amount of depreciation (bonus plus regular) deducted on the federal income tax return and then the taxpayer had to take a subtraction on the Arizona income tax return for the amount of depreciation computed under the Internal Revenue Code without bonus depreciation. This amount must be subtracted each year, until the asset is fully depreciated or until the taxpayer either sells or otherwise disposes of the asset.

The ruling provides the following example for this case:

EXAMPLE 1 - Property Placed in Service During 2012				
Taxpayer A began operation on January 1, 2012, of the taxable year. Taxpayer A immediately placed into service new 5 year property costing $100,000. The property has a $0 salvage value. Taxpayer claims bonus deprecation on the federal return and uses the straight line depreciation method. Because Arizona does not allow any bonus depreciation for an asset placed in service during 2012, Taxpayer A must complete two depreciation schedules for the asset placed in service during 2012. One computing the allowable federal depreciation calculated without bonus depreciation and the second calculated with federal bonus depreciation. The annual depreciation calculated without the federal bonus depreciation is the amount of depreciation that Taxpayer A may subtract on the Arizona income tax return. The annual depreciation calculated with the federal bonus depreciation is the amount of depreciation that Taxpayer A must add to the Arizona income reported on the Arizona income tax return.				
Federal Depreciation Schedule Calculated Using NO Bonus Depreciation (amount allowed on Arizona return)				
Year	**Depreciation**			
2012	$20,000			
2013	$20,000			
2014	$20,000			
2015	$20,000			
2016	$20,000			
Total 2012 -2016	$100,000			

Federal Depreciation Schedule WITH Bonus Depreciation Allowance (amount claimed on federal return)			
Year			**Depreciation**
	Cost	$100,000	
	Bonus depreciation %	X .50	
	Bonus depreciation	<$50,000>	$50,000
	Basis	$50,000	
2012			$10,000
2013			$10,000
2014			$10,000
2015			$10,000
2016			$10,000
Total 2012 -2016			$100,000

Based on the above depreciation schedules, Taxpayer A must make the following additions to and subtractions from Arizona gross income to reflect the depreciation allowed to be claimed on the Arizona income tax return.		
Year	**Addition**	**Subtraction**
2012	*$60,000	$20,000
2013	$10,000	$20,000
2014	$10,000	$20,000
2015	$10,000	$20,000
2016	$10,000	$20,000
Total Additions	$100,000	
Total Subtractions		$100,000
* Total depreciation claimed on federal return ($50,000 bonus plus $10,000 regular depreciation).		

Assets placed in service during 2013 is the next time period to be described. This case gets complicated because the legislature initially deferred the portion of the additional depreciation that was to be allowed and then later allowed taxpayers to elect to ignore that difference.

The ruling describes the complexities as follows:

> For a taxable year beginning in 2013, Arizona did not allow federal bonus depreciation. Therefore a taxpayer that deducted bonus depreciation for federal income tax purposes was required to make an addition to income for the total amount of depreciation (bonus plus regular) deducted on the federal income tax return. The taxpayer then must take a

subtraction on the Arizona income tax return for the amount of depreciation allowable for Arizona income tax purposes.

The amount of depreciation allowed to be taken as a subtraction on the 2013 Arizona income tax return is the amount of depreciation computed under I.R.C. § 167(a) without any federal bonus depreciation.

For assets placed in service in 2013, Arizona law allowed a taxpayer that claimed bonus depreciation on the federal return to make an election to claim bonus depreciation on the Arizona income tax return. The Arizona bonus depreciation is 10% of the amount of bonus depreciation claimed on the federal income tax return. However, a taxpayer making this election for an asset placed in service during the 2013 taxable year, had to make the election on his or her 2014 Arizona income tax return by taking the subtraction on the 2014 Arizona income tax return. Therefore, for an asset placed in service during 2013, the amount of depreciation claimed for that asset on the Arizona income tax returns filed for taxable years 2014 and later, will depend on whether the taxpayer elects to claim Arizona bonus depreciation for that asset.

If the taxpayer does not make the election to take Arizona bonus depreciation for the asset placed in service during 2013, the amount of depreciation allowed to be taken as a subtraction, for that asset, on the Arizona income tax returns filed for taxable years 2014 and later is the amount of depreciation computed under I.R.C. § 167(a) without any federal bonus depreciation. This amount must be subtracted each year, until the asset is fully depreciated or until the taxpayer either sells or otherwise disposes of the asset.

If the taxpayer makes an election to take a subtraction for Arizona bonus depreciation for an asset (for which federal bonus depreciation was claimed) placed in service during 2013, the Arizona bonus depreciation is equal to 10% of the federal bonus depreciation claimed as a deduction on the 2013 federal income tax return. A taxpayer making this election for an asset placed in service during the 2013 taxable year, must make the election on his or her 2014 Arizona income tax return by taking the subtraction on the 2014 Arizona income tax return. The taxpayer must also take a subtraction for regular depreciation, using the same method of depreciation used for federal income tax purposes, but calculated on the Arizona basis. The recomputed regular depreciation must be subtracted each year, until the asset is fully depreciated or until the taxpayer either sells or otherwise disposes of the asset.

The example is also similarly complicated.

EXAMPLE 2 - Property Placed in Service During 2013				
Taxpayer B began operation on January 1, 2013 of the taxable year. Taxpayer B immediately placed into service new 5 year property costing $100,000. The property has a $0 salvage value. Taxpayer B claimed 50% of the cost as bonus depreciation on Taxpayer B's 2013 federal income tax return. Taxpayer B uses the straight line depreciation method to depreciate the remaining basis of the property.				
Federal Depreciation Schedule Calculated Using NO Bonus Depreciation (this is the amount of depreciation that will be allowed for Arizona purposes if no 2013 AZ depreciation bonus election is made on the 2014 return.)				
Year	**Depreciation**			
2013	$20,000			
2014	$20,000			
2015	$20,000			
2016	$20,000			
2017	$20,000			
Total 2013 -2017	$100,000			

Federal Depreciation Schedule WITH Federal Bonus Depreciation Allowance (claimed on federal return)			
Year			**Depreciation**
	Cost	$100,000	
	Bonus depreciation %	X .50	
	Bonus depreciation	<$50,000>	$50,000
	Basis	$50,000	
2013			$10,000
2014			$10,000
2015			$10,000
2016			$10,000
2017			$10,000
Total 2013 -2017			$100,000

WITH 2013 AZ BONUS ELECTION Arizona Depreciation Schedule Calculated as if the 2013 Arizona Bonus Depreciation Election Were Made on the 2013 Return			
Cost			$100,000
AZ Bonus	Federal Bonus Allowed	$50,000	
	X	.10	
	AZ Bonus Depreciation	$5,000	<$5,000>
Basis for Arizona depreciation	$100,000 - $5,000		$95,000
Year			**Arizona Depreciation**
2013	AZ Bonus	$5,000	
	AZ Regular	$19,000	
2013 total			$24,000
2014			$19,000
2015			$19,000
2016			$19,000
2017			$19,000
Total 2013 -2017			$100,000

WITH 2013 AZ BONUS ELECTION ON THE 2014 RETURN Taxpayer B's Required Additions and Subtractions			
If Taxpayer B makes the 2013 Arizona bonus depreciation election on the 2014 Arizona return, Taxpayer B must make the following additions to and subtractions from Arizona gross income to reflect the depreciation allowed to be claimed on the Arizona income tax return.			
Year	**Addition**	**Subtraction**	
2013	*$60,000		$20,000
2014 – Adjustment made on 2014 return for 2013 AZ Bonus Depreciation		Allowed $24,000 Less Claimed <$20,000> Adjustment	$4,000
2014 -Regular Depreciation	$10,000		$19,000
2015	$10,000		$19,000
2016	$10,000		$19,000
2017	$10,000		$19,000
Total Additions 2013 - 2024	$100,000		
Total Subtractions 2013 - 2014			$100,000
* Total depreciation claimed on federal return ($50,000 bonus plus $10,000 regular depreciation).			

NO 2013 AZ BONUS ELECTION Taxpayer B's Required Additions and Subtractions		
If Taxpayer B claims bonus depreciation on the 2013 federal return, but **DOES NOT** make the 2013 Arizona bonus depreciation election on the 2014 Arizona return, Taxpayer B must make the following additions to and subtractions from Arizona gross income to reflect the depreciation allowed to be claimed on the Arizona income tax return.		
Year	**Addition**	**Subtraction**
2013	*$60,000	$20,000
2014	$10,000	$20,000
2015	$10,000	$20,000
2016	$10,000	$20,000
2017	$10,000	$20,000
Total Additions	$100,000	
Total Subtractions		$100,000
* Total depreciation claimed on federal return ($50,000 bonus plus $10,000 regular depreciation).		

The special rules for passenger autos also complicate the 2013 calculation, so the Department provides an example for that.

EXAMPLE 3 - Passenger Auto Placed in Service During 2013				
In May 2013, Taxpayer C bought and placed in service a car costing $31,500. The car was 5 year property under GDS (MACRS). Taxpayer C did not elect a section 179 deduction. Taxpayer C used the car exclusively for business during the recovery period.				
Federal Depreciation Schedule Calculated Using NO Bonus Depreciation (this is the amount of depreciation that will be allowed for Arizona purposes if no 2013 AZ bonus depreciation election is made on the 2014 Arizona return.)				
Year	**Percentage**	**Amount**	**Limit**	**Allowed**
2013	20.0%	$6,300	$3,160	$3,160
2014	32.0%	$10,080	$5,100	$5,100
2015	19.2%	$6,048	$3,050	$3,050
2016	11.52%	$3,629	$1,875	$1,875
2017	11.52%	$3,629	$1,875	$1,875
2018	5.76%	$1,814	$1,875	$1,814
Total 2013 -2018				$16,874
At the end of 2018, Taxpayer C has an unrecovered basis of $14,626 ($31,500-$16,874). If in years 2019 and later, Taxpayer C continues to use the car 100% for business, Taxpayer C can deduct in each of those future years, the lesser of $1,875 or the remaining unrecovered basis.				
2019			$1,875	$1,875
2020			$1,875	$1,875
2021			$1,875	$1,875
2022			$1,875	$1,875
2023			$1,875	$1,875
2024			$1,875	$1,875
2025			$1,875	$1,875
2026			$1,875	$1,501
Total 2019-2026				$14,626
Total all years				$31,500

Federal depreciation schedule calculated using federal bonus depreciation				
	Cost	$31,500		
	X .50	$15,750		
	Limit	$11,160		
Bonus Depreciation	Smaller of $15,750 or $11,160			$11,160
Basis for Depreciation	$31,500 - $11,160			$20,340
Year	**Percentage**	**Amount**	**Limit**	**Allowed**
2013	Bonus	$15,750	$11,160	$11,160
2014	32.0%	$6,509	$5,100	$5,100
2015	19.2%	$3,905	$3,050	$3,050
2016	11.52%	$2,343	$1,875	$1,875
2017	11.52%	$2,243	$1,875	$1,875
2018	5.76%	$1,172	$1,875	$1,172
Total 2013 -2018				$24,232
At the end of 2018, Taxpayer C has an unrecovered basis of $7,268 ($31,500-$24,232). If in years 2019 and later, Taxpayer C continues to use the car 100% for business, Taxpayer C can deduct in each of those future years, the lesser of $1,875 or the remaining unrecovered basis.				
2019			$1,875	$1,875
2020			$1,875	$1,875
2021			$1,875	$1,875
2022			$1,643	$1,643
Total 2019-2022				$7,268
Total all years				$31,500

WITH 2013 AZ BONUS ELECTION Arizona Depreciation Schedule Calculated as if the 2013 Arizona Bonus Depreciation Election Were Made on the 2013 Return				
Cost				$31,500
AZ Bonus	Federal Bonus Allowed	$11,160		
	X	.10		
	AZ Bonus Depreciation	$1,116		<$1,116>
Basis for Arizona depreciation	$31,500 - $1,116			$30,384
Year	**Percentage**	**Amount**	**Limit**	**Allowed**
2013	Bonus	$1,116		
	20.0%	$6,077		
2013 total		$7,193	$11,160	$7,193
2014	32.0%	$9,723	$5,100	$5,100
2015	19.2%	$5,834	$3,050	$3,050
2016	11.52%	$3,500	$1,875	$1,875
2017	11.52%	$3,500	$1,875	$1,875
2018	5.76%	$1,750	$1,875	$1,750
Total 2013 -2018				$20,843
At the end of 2018, Taxpayer C has an unrecovered basis of $10,657 ($31,500-$20,843). If in years 2019 and later years, Taxpayer C continues to use the car 100% for business, Taxpayer C can deduct in each of those future years, the lesser of $1,875 or the remaining unrecovered basis.				
2019			$1,875	$1,875
2020			$1,875	$1,875
2021			$1,875	$1,875
2022			$1,875	$1,875
2023			$1,875	$1,875
2024			$1,282	$1,282
Total 2019-2024				$10,657
Total all years				$31,500

WITH 2013 AZ BONUS DEPRECIATION ELECTION ON THE 2014 RETURN Taxpayer C's Required Additions and Subtractions			
If Taxpayer C makes the 2013 Arizona bonus depreciation election on the 2014 Arizona return, Taxpayer C must make the following additions to and subtractions from Arizona gross income to reflect the depreciation allowed to be claimed on the Arizona income tax return.			
Year	**Addition**	**Subtraction**	
2013	$11,160		$3,160
2014 – Adjustment made on 2014 return for 2013 AZ Bonus Depreciation		Allowed $7193 Less Claimed <$3160> Adjustment	$4,033
2014 -Regular Depreciation	$5,100		$5,100
2015	$3,050		$3,050
2016	$1,875		$1,875
2017	$1,875		$1,875
2018	$1,172		$1,750
2019	$1,875		$1,875
2020	$1,875		$1,875
2021	$1,875		$1,875
2022	$1,643		$1,875
2023	0		$1,875
2024	0		$1,282
Total Additions 2013 - 2024	$31,500		
Total Subtractions 2013 - 2024			$31,500

NO 2013 AZ BONUS ELECTION Taxpayer C's Required Additions and Subtractions		
If Taxpayer C claims bonus depreciation on the 2013 federal return, but **DOES NOT** make the 2013 Arizona bonus depreciation election on the 2014 Arizona return, Taxpayer C must make the following additions to and subtractions from Arizona gross income to reflect the depreciation allowed to be claimed on the Arizona income tax return.		
Year	**Addition**	**Subtraction**
2013	$11,160	$3,160
2014	$5,100	$5,100
2015	$3,050	$3,050
2016	$1,875	$1,875
2017	$1,875	$1,875
2018	$1,172	$1,814
2019	$1,875	$1,875
2020	$1,875	$1,875
2021	$1,875	$1,875
2022	$1,643	$1,875
2023	0	$1,875
2024	0	$1,875
2025	0	$1,875
2026	0	$1,501
Total Additions 2013 - 2024	$31,500	
Total Subtractions 2013 - 2014		$31,500

Arizona in 2014 and 2015 allowed 10% of the federal bonus depreciation amount. The ruling describes the treatment as follows:

> For taxable years beginning in 2014 and 2015, Arizona did not allow federal bonus depreciation. Therefore a taxpayer that deducts bonus depreciation for federal income tax purposes is required to make an addition to income for the total amount of depreciation (bonus plus regular) deducted on the federal income tax return. The

taxpayer then must take a subtraction on the Arizona income tax return for the amount of depreciation allowable for Arizona income tax purposes.

For taxable years 2014 and 2015, Arizona law required a taxpayer that claimed bonus depreciation on the federal return to claim Arizona bonus depreciation on the Arizona income tax return filed for that year. The Arizona bonus depreciation is 10% of the amount of bonus depreciation claimed on the federal income tax return. The taxpayer takes the subtraction on his or her Arizona income tax return filed for the taxable year for which the asset was placed in service and for which federal bonus depreciation was claimed. The taxpayer must also take a subtraction for regular depreciation, using the same method of depreciation used for federal income tax purposes, but calculated on the Arizona basis. This amount must be subtracted each year, until the asset is fully depreciated or until the taxpayer either sells or otherwise disposes of the asset.

The example for that period is provided below:

EXAMPLE 4 - Property Placed in Service During 2014

Taxpayer D began operation on January 1, 2014 of the taxable year. Taxpayer D immediately placed into service new 5 year property costing $100,000. The property has a $0 salvage value. Taxpayer D claimed 50% of the cost as bonus depreciation on Taxpayer D's 2014 federal income tax return. Taxpayer D uses the straight line depreciation method to depreciate the remaining basis of the property.

Federal Depreciation Schedule WITH Federal Bonus Depreciation Allowance (claimed on federal return)

Year				Depreciation
		Cost	$100,000	
		Bonus depreciation %	X .50	
		Bonus depreciation	<$50,000>	$50,000
		Basis	$50,000	
2014				$10,000
2015				$10,000
2016				$10,000
2017				$10,000
2018				$10,000
Total 2014 -2018				$100,000

Arizona Depreciation Schedule Calculated with Arizona Bonus Depreciation

Cost			$100,000
AZ Bonus	Federal Bonus Allowed	$50,000	
	X	.10	
	AZ Bonus Depreciation	$5,000	<$5,000>
Basis for Arizona depreciation	$100,000 - $5,000		$95,000
Year			**Arizona Depreciation**
2014	AZ Bonus	$5,000	
	AZ Regular	$19,000	$24,000
2015			$19,000
2016			$19,000
2017			$19,000
2018			$19,000
Total 2014 -2018			$100,000

Taxpayer D's Required Additions and Subtractions		
Year	Addition	Subtraction
2014	$60,000	$24,000
2015	$10,000	$19,000
2016	$10,000	$19,000
2017	$10,000	$19,000
2018	$10,000	$19,000
Total Additions 2014 - 2018	$100,000	
Total Subtractions 2014 - 2018		$100,000

The ruling goes on to the next change, which takes place in 2016 tax years. The ruling explains this treatment as follows:

> For a taxable year beginning in 2016, Arizona does not allow federal bonus depreciation. Therefore a taxpayer that deducts bonus depreciation for federal income tax purposes is required to make an addition to income for the total amount of depreciation (bonus plus regular) deducted on the federal income tax return. The taxpayer then must take a subtraction on the Arizona income tax return for the amount of depreciation allowable for Arizona income tax purposes.
>
> For taxable year 2016, Arizona law requires a taxpayer that claims bonus depreciation on the federal return to claim Arizona bonus depreciation on the Arizona income tax return filed for that year. The Arizona bonus depreciation is 55% of the amount of bonus depreciation claimed on the federal income tax return. The taxpayer takes the subtraction on his or her Arizona income tax return filed for the taxable year for which the asset was placed in service and for which federal bonus depreciation was claimed. The taxpayer must also take a subtraction for regular depreciation, using the same method of depreciation used for federal income tax purposes, but calculated on the Arizona basis. This amount must be subtracted each year, until the asset is fully depreciated or until the taxpayer either sells or otherwise disposes of the asset.

The ruling includes the following 2016 example.

EXAMPLE 5 - Property Placed in Service During 2016				
Taxpayer D began operation on January 1, 2016 of the taxable year. Taxpayer D immediately placed into service new 5 year property costing $100,000. The property has a $0 salvage value. Taxpayer D claimed 50% of the cost as bonus depreciation on Taxpayer D's 2016 federal income tax return. Taxpayer D uses the straight line depreciation method to depreciate the remaining basis of the property.				
Federal Depreciation Schedule WITH Federal Bonus Depreciation Allowance (claimed on federal return)				
Year				Depreciation
		Cost	$100,000	
		Bonus depreciation %	X .50	
		Bonus depreciation	<$50,000>	$50,000
		Basis	$50,000	
2016				$10,000
2017				$10,000
2018				$10,000
2019				$10,000
2020				$10,000
Total 2016 -2020				$100,000

Arizona Depreciation Schedule Calculated with Arizona Bonus Depreciation			
Cost			$100,000
AZ Bonus	Federal Bonus Allowed	$50,000	
	X	.55	
	AZ Bonus Depreciation	$27,500	<$27,500>
Basis for Arizona depreciation	$100,000 - $27,500		$72,500
Year			**Arizona Depreciation**
2016	AZ Bonus	$27,500	
	AZ Regular	$14,500	$42,000
2017			$14,500
2018			$14,500
2019			$14,500
2020			$14,500
Total 2016 -2020			$100,000

Taxpayer D's Required Additions and Subtractions		
Year	**Addition**	**Subtraction**
2016	$60,000	$42,000
2017	$10,000	$14,500
2018	$10,000	$14,500
2019	$10,000	$14,500
2020	$10,000	$14,500
Total Additions 2016 - 2020	$100,000	
Total Subtractions 2016 - 2020		$100,000

Finally, the ruling looks to the fully phased-in acceptance of bonus depreciation by Arizona in 2017 and later years.

> For assets placed in service during taxable years beginning in 2017 and later, Arizona law requires a taxpayer that claims bonus depreciation on the federal return to claim Arizona bonus depreciation on the Arizona income tax return filed for that year. The Arizona bonus depreciation is 100% of the amount of bonus depreciation claimed on the federal income tax return. The taxpayer takes the subtraction on his or her Arizona income tax return filed for the taxable year for which the asset was placed in service and for which federal bonus depreciation was claimed. The taxpayer must also take a subtraction for regular depreciation, using the same method of depreciation used for federal income tax purposes, but calculated on the Arizona basis. This amount must be subtracted each year, until the asset is fully depreciated or until the taxpayer either sells or otherwise disposes of the asset. The following example will illustrate how a taxpayer computes the required additions to and subtractions from income for property placed in service during the 2017 taxable year.
>
> **NOTE:** A taxpayer who also claims Arizona bonus depreciation for assets placed inservice prior to January 1, 2017, must compute the allowable bonus depreciation for each asset based on the allowable subtraction established for the taxable year in which the asset was placed in service.

The 2017 example is provided below.

EXAMPLE 6 - Property Placed in Service During 2017				
Taxpayer D (same Taxpayer as in Example 5) began operation on January 1, 2016 . In 2017, Taxpayer D immediately placed into service new 5 year property costing $100,000. The property has a $0 salvage value. Taxpayer D claimed 50% of the cost as bonus depreciation on Taxpayer D's 2017 federal income tax return. Taxpayer D uses the straight line depreciation method to depreciate the remaining basis of the property.				
Federal Depreciation Schedule WITH Federal Bonus Depreciation Allowance (claimed on federal return)				
Year				**Depreciation**
		Cost	$100,000	
		Bonus depreciation %	X .50	
		Bonus depreciation	<$50,000>	$50,000
		Basis	$50,000	
2017				$10,000
2018				$10,000
2019				$10,000
2020				$10,000
2021				$10,000
Total 2017 -2021				$100,000

Arizona Depreciation Schedule Calculated with Arizona Bonus Depreciation (for Assets Placed in Service during 2017)			
Cost			$100,000
AZ Bonus	Federal Bonus Allowed	$50,000	
	AZ Bonus Depreciation	$50,000	<$50,000>
Basis for Arizona depreciation	$100,000 - $50,000		$50,000
Year			**Arizona Depreciation**
2017	AZ Bonus	$50,000	
	AZ Regular	$10,000	$60,000
2018			$10,000
2019			$10,000
2020			$10,000
2021			$10,000
Total 2017 -2021			$100,000

Taxpayer D's Required Additions and Subtractions (for Assets Placed in Service during 2017)		
Year	**Addition**	**Subtraction**
2017	$60,000	$60,000
2018	$10,000	$10,000
2019	$10,000	$10,000
2020	$10,000	$10,000
2021	$10,000	$10,000
Required Additions for taxable years 2017 – 2021 for asset placed in service during 2017	$100,000	
Allowable Subtractions for taxable years 2017 – 2021 for asset placed in service in 2017		$100,000
Taxpayer D's Total Additions and Subtractions Reported for Taxable Year 2017		
	2016 Asset (see example 5) $10,000	2016 Asset (see example 5) $14,500
	2017 Asset $60,000	2017 Asset $60,000
Total Addition for taxable year 2017	$70,000	
Total Subtraction for taxable year 2017		$74,500

Finally, the ruling goes on to discuss the sale or exchange of an asset and the adjustments needed. As the ruling notes:

> If a taxpayer later sells or otherwise disposes of property for which the taxpayer made the required additions to income under A.R.S. § 43-1021(16), the taxpayer may claim a subtraction for the amount of depreciation that has been allowed pursuant to section 167(a) of the internal revenue code to the extent that the amount has not already reduced Arizona taxable income in the current or prior taxable years. This, in effect, allows the taxpayer to have the same basis for Arizona purposes as for federal purposes when the asset is sold or otherwise disposed.

The disposal example provided reads as follows:

EXAMPLE 7 - Partially Depreciated Asset Sold

Taxpayer E began operation on January 1, 2012 of the taxable year. Taxpayer E immediately placed into service new property with a cost of $100,000. The property has a $0 salvage value. Taxpayer E claimed 50% of the cost as bonus depreciation on Taxpayer E's federal income tax return filed for 2012. Taxpayer E sold the asset on January 1, 2016.

For taxable years, 2012, 2013, 2014 and 2015, Taxpayer E made all of the additions to income required under A.R.S. § 43-1021(16). Therefore, Taxpayer E would take a subtraction from income for the difference between the amount of total depreciation Taxpayer E claimed for the asset for federal income tax purposes and the amount of depreciation claimed for the asset for Arizona income tax purposes.

Federal Depreciation Straight Line 10 Year		AZ Depreciation Deduction Straight Line 10 Year	
Cost	$100,000	Cost	$100,000
Salvage	0	Salvage	0
Federal Bonus	$50,000	AZ Bonus	0
Basis	$50,000	Basis	$100,000

Year	Federal Depreciation	Federal Basis	AZ Addition Made in 2012, 2013, 2014 and 2015	AZ Depreciation Subtraction	AZ Basis
2012	$5,000	$45,000	$55,000	$10,000	$90,000
2013	$5,000	$40,000	$5,000	$10,000	$80,000
2014	$5,000	$35,000	$5,000	$10,000	$70,000
2015	$5,000	$30,000	$5,000	$10,000	$60,000

Taxpayer E sold the property on January 1, 2016 for $85,000. For federal income tax purposes, Taxpayer E reported a capital gain on the sale of the asset in the amount of $55,000 (sale price $85,000 less adjusted basis $30,000). Since the starting point for the Arizona return is the federal adjusted gross income, the $55,000 capital gain included in federal adjusted gross income will also be included in Arizona gross income. However, since Taxpayer E made all of the additions to income required under A.R.S. § 43-1021(16), Taxpayer E will be allowed to take a subtraction from income for the difference between the amount of depreciation claimed for the asset for federal income tax purposes and the amount of depreciation claimed for the asset for Arizona income tax purposes. This will, in effect, allow Taxpayer E to have the same basis for Arizona purposes as for federal purposes when the asset is sold or otherwise disposed.

Total depreciation deducted on federal returns filed for taxable years 2012, 2013, 2014 and 2015	$70,000
Less total depreciation deducted on AZ returns filed for taxable years 2012, 2013, 2014 and 2015	<$40,000>
Subtraction allowed on AZ return filed for 2016 (the year of disposition)	**$30,000**
AZ basis prior to subtraction	$60,000
Less catch-up subtraction	<$30,000>
AZ basis after catch-up subtraction	$30,000

Corporate Procedures for an Arizona Claim of Right Updated

Corporate Tax Procedure, CTP 16-1, 9/13/16

The Department of Revenue has updated the procedure for tax returns where there is a restoration of a substantial claim of right for corporations (CTP 16-1), superseding CTP 95-3.

The claim of right doctrine deals with a situation where a taxpayer receives an unrestricted right to the use of funds in one year, but in a later year it is determined the taxpayer must repay those funds. The income is included in the year received despite the fact that it must be repaid later.

The ruling begins by describing the federal options when such an amount is repaid.

> For federal income tax purposes, there are two different methods to compute the tax for the year in which amounts held under a claim of right are required to be repaid. A taxpayer may take a deduction for the repayment of an amount held under a claim of right or claim a "credit." The credit is equal to the amount of tax for the prior year that was attributable to the inclusion of the repaid amount. The taxpayer must use the method that results in the lesser amount of tax.

Arizona does not allow for a deduction, but rather only allows a taxpayer to claim a credit for restoration of a substantial claim of right. If a deduction was claimed on the federal return, it must be added back for Arizona purposes.

The ruling goes on to note:

> Since the adjustment is made for the year of repayment, the return for the prior year in which the income item was received is not reopened and there is no allowance for interest on the tax paid for the earlier year. However, since the restoration will have the effect of negating the income that was included in a prior year under a claim of right, any net operating loss or capital loss that would have existed had the income not been included will be established. Such losses are to be utilized in calculating the tax decrease for the taxable year in which the amounts were included and the tax decrease for taxable years to which the losses could have been carried. Any remaining loss is to be carried forward and applied to taxable years subsequent to the year of restoration.

Arizona's claim of right rule for corporations is found at ARS §43-1130.01. Those provisions must be used when:

- The taxpayer included an item of income in the gross income of a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item.
- After the close of the prior taxable year (or years) it was established that the taxpayer did not have an unrestricted right to all or part of the item.
- A deduction for the repayment is allowable under the Internal Revenue Code or Title 43 of the Arizona Revised Statutes. For example, the repayment may constitute a deductible trade or business expense, profit seeking expense, or a deductible loss.
- The amount of the deduction exceeds $3,000.

Arizona's rule does not apply in the following cases.

- An item that was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer; or
- Other property of a kind that would properly have been included in the inventory of the taxpayer on hand at the close of the prior taxable year; or
- Property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

The exceptions do not apply to payments or refunds of a regulated public utility (see ARS §43-1130.01(D)).

The credit represents a recomputation of the year when the income was included. The ruling outlines this calculation as follows:

> When a taxpayer is required to compute its tax under A.R.S. § 43-1130.01, the Arizona income tax is the tax for the taxable year less the Arizona income tax decrease for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for the prior taxable year (or years).
>
> When computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, the taxpayer must first ascertain the amount of tax previously determined for the taxpayer for such prior taxable year (or years).
>
> The tax previously determined is the sum of the amounts shown by the taxpayer on its return (or returns), plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which appropriately should be assessed or collected, reduced by the amount of any refunds or credits which have previously been made or which appropriately should be made.
>
> After the taxpayer has ascertained the tax previously determined, it must then determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable.

The ruling contains the following examples.

<u>Example 1:</u>

> For the taxable year 2013, a corporation had Arizona taxable income of $35,000 consisting entirely of sales commissions on which it paid Arizona income tax of $2,439 (there were no tax credits for the year). In 2016, it was determined that the commissions were erroneously computed for 2013. Accordingly, the taxpayer pays back $10,000 of the commissions.

The taxpayer's taxable income for 2016, without regard to the $10,000 repayment, was $12,000. The tax on $12,000 is $660. Therefore, the taxpayer enters $660 on its 2016 Arizona income tax return on the line for computing the 2016 tax.

Under A.R.S. § 43-1130.01, this taxpayer computes the decrease in tax for 2013 as follows:

Tax Paid in 2013 on $35,000	$2,439
Tax Payable in 2013 on $25,000	1742
Decrease in prior year's tax	$ 697

he $697 is treated as having been paid on the last day prescribed by law for the payment of the tax for 2016. Therefore, the excess of $37 ($697 - $660) may be refunded to the taxpayer.

Example 2:

For the taxable year 2010, a corporation had Arizona taxable income of $75,000 consisting of the following:

Capital gain	$90,000
Capital loss	<30,000>
Ordinary income	15,000
Taxable income	$75,000

On the taxable income of $75,000, the taxpayer paid Arizona income tax of $5,226 (there were no tax credits for the year).

In taxable year 2015, the taxpayer is required to restore the $90,000 capital gain. The taxpayer's taxable income for 2015, without regard to the $90,000 repayment, was $50,000.

Due to the restoration of the 2010 capital gain, this taxpayer has a $30,000 capital loss for the 2010 taxable year. Therefore, when this taxpayer computes the decrease in tax, it must compute a tax decrease for all taxable years to which it carries over or back a portion of the capital loss against any capital gains. (The example assumes no capital gain in the three years prior to 2010 to which the loss could be carried back, capital gains of $5,000 in years 2011 and 2014, and $40,000 of taxable income in each year.) Since the capital loss may be carried over to the extent of capital gain, the taxpayer may apply that amount of the loss carryover to each taxable year which reports capital gain (2011 and 2014). The remaining $20,000 of capital loss would be lost due to the five year limitation on loss carryforwards.

For each of the taxable years 2011, 2012, 2013, and 2014 the taxpayer had taxable income of $40,000.

The taxpayer's taxable income for 2015, without regard to the $90,000 repayment was $50,000. The tax on $50,000 is $3,000. Therefore, the taxpayer enters $3,000 on its 2015 Arizona corporate income tax return on the line for computing the 2015 tax.

Under A.R.S. § 43-1130.01, this taxpayer computes the decrease in tax for 2010, 2011, and 2014, as follows (2012 and 2013 remain unchanged since there was no capital gain):

Tax paid in 2010 on $75,000	$ 5,226	
Tax payable in 2010 on $15,000	$ 1,045	$ 4,181
Tax paid in 2011 on $40,000	$ 2,787	
Tax payable in 2011 on $35,000	$ 2,439	$ 348
Tax paid in 2014 on $40,000	$ 2,600	
Tax payable in 2014 on $35,000	$ 2,275	$ 325
Total Decrease in prior years' tax		$ 4,854

The $4,854 is treated as having been paid on the last day prescribed by law for the payment of the tax for 2015. Therefore, the excess of $1,854 ($4,854 - $3,000) may be refunded to the taxpayer.

The ruling also provides procedures for amounts repaid in taxable years beginning after December 31, 2015:

- Complete and include the department's Claim of Right Form for each prior tax year that included income that was repaid during the current tax year. This form is available on the department's website and can be downloaded from the corporate forms page. Use the Arizona Claim of Right-Corporate Form for the year in which the amount is repaid (and the credit is claimed), not the form for the year the income was reported. Be sure to use the correct Claim of Right Form for the tax return you are filing.
- A line is provided on the tax return to report the claim of right credit amount.
- For information on how to complete a Claim of Right Form and how to report the claim of right credit, see the specific instructions for the Claim of Right-Corporate Form.

For amounts beginning before December 31, 2015 the following procedures are to be used:

- Complete and include your own schedule showing (1) each prior taxable year that included an amount repaid during the current tax year and (2) the computation for the decrease in tax for each prior tax year.
- On the tax return in which you are claiming the claim of right credit, write "A.R.S. 43-1130.01" on the line identified as Total Payments and enter the total amount of the decrease (claim of right credit) next to it.
- Include the claim of right credit amount in the total amount entered for Total payments.

Individual Procedures for an Arizona Claim of Right Updated

Individual Income Tax Procedure, ITP 16-1, 9/13/16
The Department of Revenue has updated the procedure for tax returns where there is a restoration of a substantial claim of right for individuals (ITP 16-1), superseding ITP 95-1.

The claim of right doctrine deals with a situation where a taxpayer receives an unrestricted right to the use of funds in one year, but in a later year it is determined the taxpayer must repay those funds. The income is included in the year received despite the fact that it must be repaid later.

The ruling begins by describing the federal options when such an amount is repaid.

> For federal income tax purposes, there are two different methods to compute the tax for the year in which amounts held under a claim of right are required to be repaid. A taxpayer may take a deduction for the repayment of an amount held under a claim of right or claim a "credit." The credit is equal to the amount of tax for the prior year that was attributable to the inclusion of the repaid amount. The taxpayer must use the method that results in the lesser amount of tax.

Arizona does not allow for a deduction, but rather only allows a taxpayer to claim a credit for restoration of a substantial claim of right. If a deduction was claimed on the federal return, it must be added back for Arizona purposes.

The ruling goes on to note:

> Since the adjustment is made for the year of repayment, the return for the prior year in which the income item was received is not reopened and there is no allowance for interest on the tax paid for the earlier year. However, since the restoration will have the effect of negating the income that was included in a prior year under a claim of right, any net operating loss or capital loss that would have existed had the income not been included will be established. Such losses are to be utilized in calculating the tax decrease for the taxable year in which the amounts were included and the tax decrease for taxable years to which the losses could have been carried. Any remaining loss is to be carried forward and applied to taxable years subsequent to the year of restoration.

Arizona's claim of right rule for corporations is found at ARS §43-1029. Those provisions must be used when:

- The taxpayer included an item of income in the gross income of a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item.
- After the close of the prior taxable year (or years) it was established that the taxpayer did not have an unrestricted right to all or part of the item.
- A deduction for the repayment is allowable under the Internal Revenue Code or Title 43 of the Arizona Revised Statutes. For example, the repayment may constitute a deductible trade or business expense, profit seeking expense, or a deductible loss.
- The amount of the deduction exceeds $3,000.

Arizona's rule does not apply in the following cases.

- An item that was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer; or
- Other property of a kind that would properly have been included in the inventory of the taxpayer on hand at the close of the prior taxable year; or
- Property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

The credit represents a recomputation of the year when the income was included. The ruling outlines this calculation as follows:

> When a taxpayer is required to compute his or her tax under A.R.S. § 43-1029, the Arizona income tax is the tax for the taxable year less the Arizona income tax decrease for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for the prior taxable year (or years).
>
> When computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, the taxpayer must first ascertain the amount of tax previously determined for the taxpayer for such prior taxable year (or years).
>
> The tax previously determined is the sum of the amounts shown by the taxpayer on the taxpayer's return (or returns), plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which appropriately should be assessed or collected, reduced by the amount of any refunds or credits which have previously been made or which appropriately should be made.
>
> After the taxpayer has ascertained the tax previously determined, the taxpayer must then determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable.

The ruling contains the following examples.

<u>Example 1:</u>

> For the taxable year 2013, a single individual had Arizona taxable income of $35,000 consisting entirely of sales commissions on which he paid Arizona income tax of $1,028 (there were no tax credits for the year). In 2016, it was determined that the commissions were erroneously computed for 2013. Accordingly, the taxpayer pays back $10,000 of the commissions.
>
> The taxpayer's taxable income for 2016, without regard to the $10,000 repayment, was $12,000. The tax on $12,000 is $317. Therefore, the taxpayer enters $317 on his 2016 Arizona income tax return on the line for computing the 2016 tax.
>
> Under A.R.S. § 43-1029, this taxpayer computes the decrease in tax for 2013 as follows:

Tax Paid in 2013 on $35,000	$1,028
Tax Payable in 2013 on $25,000	692
Decrease in prior year's tax	$ 336

The $336 is treated as having been paid on the last day prescribed by law for the payment of the tax for 2016. Therefore, the excess of $19 ($336 - $317) may be refunded to the taxpayer.

Example (2):

Facts:

For the taxable year 2010, a single individual had Arizona taxable income of $65,000 consisting of the following:

Capital gain	$90,000
Capital loss	<30,000>
Ordinary income	15,000
Itemized deductions	<8,000>
Personal exemption	<2,000>
Taxable income	$65,000

On the taxable income of $65,000, the taxpayer paid Arizona income tax of $2,167 (there were no tax credits for the year).

In taxable year 2015 the taxpayer is required to restore the $90,000 capital gain. The taxpayer's taxable income for 2015, without regard to the $90,000 repayment, was $50,000.

Due to the restoration of the 2010 capital gain, this taxpayer has a $30,000 capital loss for the 2010 taxable year. Therefore, when this taxpayer computes the decrease in tax, he must compute a tax decrease for taxable years 2011, 2012, 2013, and 2014. (For simplicity, the example assumes no capital gains in subsequent years and the same amount of ordinary income in each year.) Since the capital loss must be carried over to the same extent and in the same manner as provided for federal income tax purposes, the taxpayer must apply $3,000 of the loss carryover to each prior taxable year (2010, 2011, 2012, 2013, and 2014 and $3,000 to the current taxable year 2015. The remaining $12,000 of capital loss must be carried forward and utilized for taxable year 2016 and succeeding taxable years.

For each of the taxable years 2011, 2012, 2013, and 2014, the taxpayer had taxable income of $40,000. For each of these years, the taxpayer's Arizona income tax was $1,196.

Since the taxpayer will apply $3,000 of the capital loss carryover to 2015, the taxpayer will compute the 2015 tax, as follows:

Tax (using 2015 tax table X) on $47,000 ($50,000 less $3,000 2010 capital loss carryover)	$ 1,429

Therefore, the taxpayer enters $1,429 on his 2015 Arizona income tax return on the line for computing the 2015 tax.

Under A.R.S. § 43-1029, this taxpayer computes the decrease in tax for 2010, 2011, 2012, 2013, and 2014, as follows:

Tax paid in 2010 on $65,000	$ 2,167	
Tax payable in 2010 on $2,000 ($15,000 ordinary income, less $3,000 capital loss, less $10,000 personal exemption and itemized deductions)	$ 52	$ 2,115
Tax paid in 2011 on $40,000	$ 1,196	
Tax payable in 2011 on $37,000	$ 1,095	$ 101
Tax paid in 2012 on $40,000	$ 1,196	
Tax payable in 2012 on $37,000	$ 1,095	$ 101
Tax paid in 2013 on $40,000	$ 1,196	
Tax payable in 2013 on $37,000	$ 1,095	$ 101
Tax paid in 2014 on $40,000	$ 1,196	
Tax payable in 2014 on $37,000	$ 1,095	$ 101
Total Decrease in prior years' tax		$ 2,519

The $2,519 is treated as having been paid on the last day prescribed by law for the payment of the tax for 2015. Therefore, the excess of $1,090 ($2,519 - $1,429) may be refunded to the taxpayer.

The ruling also provides procedures for amounts repaid in taxable years beginning after December 31, 2015:

- Complete and include the department's Claim of Right Form for each prior tax year that included income that was repaid during the current tax year. This form is available on the department's website and can be downloaded from the Forms page for the tax return you are filing (individual or fiduciary). Use the Claim of Right Form for the year in which the amount is repaid (and the credit is claimed), not the form for the year the income was reported. Be sure to use the correct Claim of Right Form for the tax return you are filing.
- A line is provided on the tax return to report the claim of right credit amount.
- For information on how to complete a Claim of Right Form and how to report the claim of right credit, see the specific instructions for the Claim of Right Form you are filing (Individual or Fiduciary).

For amounts beginning before December 31, 2015 the following procedures are to be used:

- Complete and include your own schedule showing (1) each prior taxable year that included an amount repaid during the current tax year and (2) the computation for the decrease in tax for each prior tax year.
- On the tax return in which you are claiming the claim of right credit, write "A.R.S. 43-1029" on the line identified as Total Payments and refundable credits and enter the total amount of the decrease (claim of right credit) next to it.
- Include the claim of right credit amount in the total amount entered for Total payments and refundable credits.

Healthcare Company Under Contract to AHCCCS Subject to Premium Tax Not Subject to Income Tax

Taxpayer Information Ruling LR15-007, 7/14/16
In a Taxpayer Information Ruling (LR15-007) the Department of Revenue explained that a healthcare company with subsidiaries that are contractor entities subject to and paying the Arizona premium tax are exempt from the corporate income taxes.

The letter provides the following facts:

> Arizona has a Medicaid insurance program for qualifying Arizona consumers called Arizona Health Care Cost Containment System "AHCCCS". AHCCCS enters contracts with health maintenance organizations and other companies (called "AHCCCS contractors") to provide health insurance plans for qualifying Arizona consumers. The contracts between AHCCCS and the contractors are prepaid capitated contracts that require the contractors to assume the risk of providing health insurance coverage for a flat fee.
>
> XYZ, Inc. ("XYZ") is a health care company incorporated and domiciled outside of the state of Arizona. ABC, Inc. ("ABC") is a subsidiary of XYZ that is incorporated and domiciled in Arizona. ABC has a contract with the AHCCCS to provide health insurance benefits. The majority of ABC's revenues are derived from its contract with the AHCCCS. ABC also earns revenue by providing health care benefits through the Arizona Department of Economic Security Division for Developmental Disabilities and the Centers for Medicare and Medicaid Services. DEF, Inc. ("DEF") is also a subsidiary of XYZ. DEF is incorporated and domiciled in Arizona.
>
> DEF has a contract with the AHCCCS to provide health insurance benefits to qualifying Arizona consumers. DEF's revenues are solely derived from this contract. DEF subcontracts with medical providers within Arizona to provide health care.
>
> Both ABC and DEF are subject to Arizona premium tax under A.R.S. § 36-2905 because of their status as AHCCCS contractors. ABC and DEF and paid substantial amounts of tax, accordingly. have filed Arizona premium tax returns,

The taxpayer's position was explained as follows:

> ABC and DEF are exempt from paying Arizona corporate income tax under A.R.S. § 43-1201(A)(14) as: (1) ABC and DEF are paying premium tax to Arizona; and, (2) ABC and DEF are "insurance companies" for purposes of this exemption because they provide health insurance to Arizona consumers who qualify for AHCCCS services.

The Department agreed with the taxpayer's position.

> ABC and DEF are engaged in the business of administering and providing health insurance plans to Arizona consumers who qualify for AHCCCS services. AHCCCS compensates ABC and DEF through a prepaid capitated fee. As entities that have a prepaid capitated contracts to provide health care to members, ABC and DEF are considered contractors for purposes of A.R.S. § 36-2901(3). As required under A.R.S. § 36-2905, contractors ABC and DEF must both pay a two percent tax based on the total capitation, including reinsurance, and any other reimbursement paid to the contractors. Under A.R.S. § 36-2901(13) "prepaid capitated" means a mode of payment by which a health care contractor directly delivers health care services for the duration of a contract to a maximum specified number of members based on a fixed rate per member notwithstanding the actual number of members who receive care from the contractor or the amount of health care services provided to any member. The prepaid capitation fee ABC and DEF receive is not based on actual use during the life of the contract. ABC and DEF assume the risk that the capitated fee will cover services provided under the health insurance coverage they provide to AHCCCS qualifying consumers and indemnify the consumers for the health care they receive. This arrangement suggests ABC and DEF are "persons" providing "insurance" and therefore are operating as "insurers". "Insurers" is a defined term that can reasonably substituted with the phrase "insurance companies" found in Title 43.
>
> The two percent tax ABC and DEF remit to the Department of Insurance based on their prepaid capitated fee is identified as a premium tax under A.R.S. § 36-2905(D) & (E). Under A.R.S § 43-1201(A)(14) insurance companies that pay premium tax on income from Arizona sources are exempt from Arizona's corporation income tax. A.R.S. § 43-1201(A)(14) does not require the premium tax paid by an insurance company to be assessed under Title 20, only that a premium tax is paid. In previous rulings, the Department has relied on Arizona Attorney General's opinions, relevant case law and the "in lieu" statutory language found in A.R.S. § 20-226 in determining whether Arizona's corporation income tax applies to insurers. However, in this matter ABC and DEF are actually paying a premium tax so no such analysis is necessary. ABC and DEF are the functional equivalent of insurance companies and remit a two percent premium tax to the Department of Insurance. As such, for purposes of Title 43 both ABC and DEF are insurance companies paying premium tax on income derived from Arizona sources and therefore exempt from Arizona's corporation income tax.

Rules for Withholding of Arizona Income Taxes from Tips Explained

Withholding Tax Ruling WTR 16-1, 7/25/16

The rules for withholding Arizona Income tax from tips have been updated in Arizona Withholding Tax Ruling (WTR 16-1), superseding WTR 92-1.

The ruling looked to answer two issues:

- When the amount required to be deducted by an employer is more than the employee's regular wage (the wages under the control of the employer) due to the requirement to withhold on tip income, does Arizona recognize the federal priorities established by Treas. Reg. § 31.3402(k)-1?
- If Arizona does recognize the federal priorities for withholding taxes, will the employer still be required to remit the total withholding for Arizona purposes when the amount required to be deducted by the employer is more than the amount of wages under the control of the employer?

The ruling notes the following general rules for Arizona withholding in this case:

> For Arizona withholding tax purposes, tips which are reported to an employer by an employee which are subject to federal withholding are likewise subject to Arizona withholding. In the situation where the amount of required federal and Arizona withholding on tip income exceeds the amount of wages available from which withholding may be made, the Department will recognize the payment application structure established by Treas. Reg. § 31.3402(k)-1. The employer is required to withhold as follows:
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> 1. The employer is first required to withhold federal and Arizona taxes imposed on the regular wage.
> 2. After the required withholding in number 1 has been satisfied, the remaining regular wage must then be used to satisfy the required federal withholding imposed on the employee's tip income.
> 3. After the withholding required in numbers 1 and 2 have been satisfied, the remaining regular wage, if any, must be used to satisfy the applicable Arizona withholding on the tip income.
>
> Therefore, in this situation, the employer is only required to withhold Arizona taxes on tip income to the extent that the tax can be deducted and withheld from the wages under the employer's control. If the current wage under the employer's control is not sufficient to satisfy the amount required to be withheld for Arizona purposes, then the employer must withhold such unsatisfied amounts from the remaining regular wage in the following pay period or succeeding pay periods during the calendar year.

Arizona Withholding Rules on Employee Benefits Addressed

Withholding Tax Ruling WTR 16-2, 7/25/16

The withholding of Arizona income taxes on employee benefits is addressed in the revised Withholding Tax Ruling WTR-16-2, which supersedes WTR 93-1.

In this case, the issued being addressed is:

> Are amounts paid for employee benefits considered to be a payment of wages subject to Arizona withholding?

The Department's ruling is:

> Amounts paid for employee benefits that are included in wages and subject to mandatory federal withholding re subject to Arizona withholding, unless the employment is excluded from Arizona withholding. Amounts excluded from mandatory federal withholding are similarly excluded from Arizona withholding.

Arizona Income Tax Withholding Not Required for Domestic Services

Withholding Tax Ruling WTR 16-3, 7/25/16
An updated ruling (Arizona Withholding Tax Ruling WTR 93-2) has been issued regarding Arizona individual income tax withholding on domestic services such as baby-sitter, governess or nanny services performed in a private home. The ruling supersedes WTR 93-2.

The issue being addressed in this ruling is:

> Can Arizona income taxes be withheld from compensation paid to a baby-sitter, governess, or nanny for services performed in a private home?

The ruling holds:

> Arizona does not allow withholding to be deducted or retained from wages paid for domestic service in a private home. For purposes of the Arizona income tax withholding exclusion, compensation paid for services performed by a baby-sitter, governess or nanny, in or about a private home, is considered to be wages for domestic service in a private home. Therefore, Arizona withholding is not required on such compensation and cannot be elected.

Arizona Will Follow IRS Determination of Employee Status

Withholding Tax Ruling WTR 16-4, 7/25/16
The Arizona Department of Revenue in Withholding Tax Ruling WTR 16-4 has updated guidance on the determination of employee status for income tax withholding, superseding WTR 93-3.

The issue to be decided in the ruling is:

> For withholding tax purposes, does the Arizona Department of Revenue accept an Internal Revenue Service determination regarding whether a worker is an employee or an independent contractor?

The ruling holds:

> For withholding tax purposes, the Department of Revenue will follow the determination of the Internal Revenue Service with respect to a worker's status as employee or independent contractor.

Arizona Income Tax Withholding on Pensions and Annuities Ruling

Withholding Tax Ruling WTR 16-5, 7/25/16
The Department of Revenue updated its guidance on Arizona income tax withholding for pensions and annuities in Withholding Tax Ruling WTR 16-5, superseding WTR 99-2.

The issue is stated in the ruling as:

> Is withholding required on the amount of a pension or annuity paid to an individual taxed in Arizona?

The ruling provides:

> Arizona withholding is not required on pension or annuity payments. However, a taxpayer may elect voluntary withholding on pensions or annuities that are required to be included in the individuals Arizona gross income. If the election is made, the payment of the pension or annuity shall be treated as if it were the payment of wages by an employer to an employee.