

Arizona Income Tax Law Update

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Tax Updates

- Maintain weekly podcast of tax update items found at <http://www.edzollarstaxupdate.com>
- Deals mainly with federal issues, though some Arizona items are discussed
- Are audio files that average about one half hour on various issues

Arizona Resources

- ADOR website (<http://www.azdor.gov>) has links to many binding (and nonbinding) source documents
 - Arizona Revised Statutes
 - Regulations & Rulings
- Paid Publications
 - Source document services (Kleinrocks, Tax Analysts)
 - CCH, RIA have Arizona guides
 - Arizona Income Tax Guide (Phoenix Tax Workshop—I am a co-author this coming year)

Basics of Arizona Law

- Conformity Issue
 - Arizona Income Tax Law in Title 43 of Arizona Revised Statutes, with administrative provisions and other tax laws in Title 42
 - Arizona Income Tax mainly borrows its provisions from the Internal Revenue Code
 - Means that, in general, the answer to the tax status of an item is the federal answer unless there is specific authority for another answer
 - Internal Revenue Code adopted as it exists on a specific date

Basics of Arizona Law

- Individuals
 - Start with federal AGI, add items specified in ARS §43-1021, subtract items specified in ARS §43-1022
 - Itemized Deduction definitions generally borrowed from IRC with slight modification (medical haircut pulled, credit adjustments)
- Corporations
 - Start with federal taxable income
 - Add specified items from ARS §43-1121, less items specified in ARS §43-1122

Basics of Arizona Law

- The Legislation, Congress and the Arizona Constitution
 - Legislature has one regular session each year beginning in January
 - Can only come back under special session rules
 - Congress passes tax laws all year
- Enter Each Tax Season with Conformity Issues
 - Tends to be resolved in May
 - Have to make a decision on what the Legislature is going to do

Basics of Arizona Law

- Issues Driving Conformity
 - Budget issues tend to drive conformity with federal provisions that reduce revenue
 - Policy positions tend to be used to create nonconformity by introducing breaks
 - Legislature has grown to love credits
 - Property tax reform for businesses may also impact this area

Arizona Law Changes

- Internal Revenue Code Conformity
 - Arizona adopted the 2004 changes that Congress passed
 - Qualified Production Activities
 - Repeal of ETI
 - Various “abuse” provisions, including nonqualified deferred compensation and documentation on auto donations
 - Arizona did not undo any prior nonconformity items
 - Bonus depreciation is solving itself
 - Section 179 is still a major nonconformity issue

Arizona Law Changes

- Internal Revenue Code Conformity
 - Will Have 2005 Issues Still in Question
 - Katrina bill—charitable contribution limit is the big issue for now
 - Anything Congress might put in the budget reconciliation bill
 - Marriage Penalty Relief
 - Bringing major credits for married couples to 2 times single amount
 - Phased in, so only partial relief for 2005
 - \$300 for public school and working poor credits (\$400 in 2006)
 - \$825 for private school tuition (\$1,000 in 2006)

Arizona Law Changes

- Internal Revenue Code Conformity
 - Standard deduction to be indexed to Metropolitan Phoenix Consumer Price Index
 - Appears to require that ADOR set this based on year end numbers—could be an issue in getting forms out

Arizona Law Changes

- Tentative Change in Apportionment Factors
 - Contingent upon certain investments being made in Arizona (Intel, specifically)
 - If all tests passed, will go to higher sales factors (up to 80% in 2009)
 - Meant to lower the tax on entities that sell most of their goods outside Arizona
 - Use of this new factor is elective—may still use the old factors if preferable

Arizona Law Changes

- Withholding Election by Employers
 - Legislature's Christmas present
 - Employer determines for all employees whether will or won't withhold
 - In 2005, had to notify employees by October 1 (though ADOR gave a break)
 - In 2006 and later years, will have to give notice by July 1 if an employer plans to use this
 - Notify ADOR on Form AE-1

Arizona Law Changes

- 2006 Subtraction for Military Pay
 - Excludes pay not already excluded from income
 - Only active service pay excluded
 - Not codified—it exists as session law only
 - Would expect someone to try and extend this provision

Arizona Law Changes

- Credit for Investment in Qualified Small Business
 - Complex provision that is meant to attract venture capital funds
 - Credit is preapproved by Commerce Department
 - Department of Commerce begins receiving applications on July 1, 2006

Arizona Law Changes

- Credit for Motion Picture Production Costs
 - Available for Arizona productions meeting certain criteria from 2006-2010
 - From 10% to 20% of costs based on total costs paid in Arizona
 - Credits can be transferred to other parties—including being sold
 - Caps are imposed on total credit for all taxpayers and individual taxpayers
 - Can be carried forward five years

Arizona Law Changes

- Credit for Employing National Guard Members
 - Begins in 2006
 - \$1,000 credit per employee per year
 - Employee must be placed on active duty for a period exceeding the required annual training period
 - No requirement that employer continue to pay employee while away
 - Federal law requires job be made available after return from service

Arizona Law Changes

- Credit for Water Conservation Systems
 - 2007-2012 years
 - 25% of cost of installing a graywater conservation system
 - Maximums
 - \$1,000 per year
 - \$1,000 per specific residence
 - Overall statewide cap of \$250,000 (requires precertification to claim credit)
 - Taxpayer must not be a dependent of another
 - Graywater stubouts installed prior to purchase do not qualify

Arizona Law Changes

- Builder's Credit for Water Conservation System Stub-Outs
 - 2007-2012
 - Homebuilder gets credit of \$250 per house or dwelling unit for installing graywater stubouts
 - Credits must be preauthorized by the ADOR and are capped statewide at \$500,000 per year

Arizona Law Changes

- National Guard Relief Fund Checkoff Box
 - Starts on 2006 Returns
 - New box for donations on tax return

Administrative Regulations

- Credits for Taxes Paid to Another State or Country, Property Tax Credit
 - Clarified definition of Arizona taxes to be amount paid after all credits (including clean elections credit)
 - Similar rule for other state's taxes
- Property Tax Credit
 - Will now be claimed on Form 201

Tax Rulings

- Alternative Methods of Signing for Tax Return Preparers
 - Meant to allow similar “alternative” methods to those allowed under IRS procedure last year (the PDF/fax rule)
 - Methods allowed include
 - Rubber stamp
 - Mechanical device
 - Computer software program
 - Must include
 - Facsimile of preparer’s signature or
 - Printed version of preparer’s name

Tax Rulings

- Dependency Exemption When Taxpayer Does Not Claim a Federal Exemption in Order to Claim The Education Credit
 - Under IRS Regulations, allowed to leave child off who otherwise could be claimed in order to allow child to claim education credits
 - Arizona does not require child be claimed on federal return (though ADOR had informally indicated otherwise last tax season), so can claim child if qualify to do so

Other Correspondence

- Arizona Transaction Privilege Tax on Purchase of Residence is Not a General Sales Tax
 - IRS Allows Sales Tax Paid on Residence to Be Added to Table Amount
 - Arizona Department of Revenue Cites IRS Private Letter Ruling 8249010
 - Holds the tax on contracting is not a “general sales tax”
 - Effective rate is 65% of standard rate
 - Federal law only allows general rate
 - Would also have problem that, in most cases, taxpayer doesn’t buy from contractor entity

Selected Judicial Cases

- Private School Tuition Organization Credit Upheld As Constitutional on Second Pass Through Federal Courts
 - Second pass through the federal courts
 - Supreme Court held that federal courts had jurisdiction, reversing original holding of district court
 - U.S. District Court in Arizona held that it did not violate First Amendment since statute neutral and secular on its face

Selected Judicial Cases

- Alternative Fuels Credit Repeal Was Constitutional
 - Arizona Court of Appeals turns down taxpayer appeal of lower court loss
 - Held did not violate due process
 - Was not a contract with the state

Selected Judicial Cases

- Building Homes and Selling the Mortgages Was a Unitary Business for Apportionment Purposes
 - Related corporations built and sold homes, provided financing and resold mortgages
 - Corporation wanted to count sales of mortgages as non-Arizona revenue
 - Court ruled had to include gain in both numerator and denominator as Arizona sourced

Arizona Issues

- S Corporation Issues
 - Very little in the law (only one skeletal section in Title 42)
 - No addition or subtraction provision in individual sections
 - Arizona Department of Revenue has held there is no adjustment
 - However, any individual limits will still apply (§179)
 - As well, Constitutional adjustments apply (U.S. Interest)

Arizona Issues

- Section 179
 - Applies the \$25,000 limit
 - Recover the excess over five years
 - Does not matter if the property is sold or otherwise disposed
 - The problem of converting to S (lose the difference)

Arizona Issues

- §168(k) “Bonus” Depreciation Issues
 - Has now basically expired in the federal law (though Katrina relief may bring it back in some minor form)
 - However, still have to deal with old assets
 - Had retroactive fix passed a couple of years ago
 - Have different basis for Arizona and federal purposes (but beware of S corporation election)
 - Can now claim “lost” basis on sale

Arizona Issues

- Fiduciary Returns
 - Resident vs. nonresident for Arizona
 - Estate—look at residency of decedent at date of death
 - Trust—any trustee an Arizona resident on last day of trust year makes trust an Arizona resident trust
 - Resident trust taxed on all income from all sources
 - Other states have very different rules here