Arizona Income Tax Law Update

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Tax Updates

- Maintain weekly podcast of tax update items found at http://www.edzollarsstataxupdate.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

<table>
<thead>
<tr>
<th>Individuals</th>
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<tbody>
<tr>
<td>- Start with federal AGI, add items specified in ARS §43-1021, subtract items specified in ARS §43-1022</td>
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<tr>
<td>- Itemized Deduction definitions generally borrowed from IRC with slight modification (medical haircut pulled, credit adjustments)</td>
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<table>
<thead>
<tr>
<th>Corporations</th>
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<tbody>
<tr>
<td>- Start with federal taxable income</td>
</tr>
<tr>
<td>- Add specified items from ARS §43-1121, less items specified in ARS §43-1122</td>
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### Basics of Arizona Law

<table>
<thead>
<tr>
<th>The Legislation, Congress and the Arizona Constitution</th>
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<tbody>
<tr>
<td>- Legislature has one regular session each year beginning in January</td>
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<td>- Can only come back under special session rules</td>
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<tr>
<td>- Congress passes tax laws all year</td>
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<table>
<thead>
<tr>
<th>Enter Each Tax Season with Conformity Issues</th>
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<tbody>
<tr>
<td>- Tends to be resolved in May</td>
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<tr>
<td>- Have to make a decision on what the Legislature is going to do</td>
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### Basics of Arizona Law

<table>
<thead>
<tr>
<th>Issues Driving Conformity</th>
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<tbody>
<tr>
<td>- Budget issues tend to drive conformity with federal provisions that reduce revenue</td>
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<tr>
<td>- Policy positions tend to be used to create nonconformity by introducing breaks</td>
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<tr>
<td>- Legislature has grown to love credits</td>
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<tr>
<td>- Property tax reform for businesses may also impact this area</td>
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### Arizona Law Changes

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

- 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

- **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—excluding 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 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

- **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
    - Fascimile of preparer’s signature or
    - Printed version of preparer’s name

- **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