ARIZONA CORPORATE INCOME TAX PROCEDURE

CTP 95-3

Procedure for Corporations That Restore Substantial Amounts Held Under a Claim of Right

ISSUE:

How does a corporation that restores a substantial amount held under a claim of right compute its Arizona income tax liability for the year in which the amounts are restored (repaid)?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-1101.2 provides that the Arizona taxable income of a corporation is its federal taxable income adjusted by the modifications specified in A.R.S. §§ 43-1121 and 43-1122.

A.R.S. § 43-1121.20 requires an addition for the deduction referred to in Internal Revenue Code (I.R.C.) § 1341(a)(4) for restoration of a substantial amount held under a claim of right.

A.R.S. § 43-1121.21 requires an addition for the amount by which a capital loss carryover allowable pursuant to I.R.C. § 1341(b)(5) exceeds the capital loss carryover allowable pursuant to A.R.S. § 43-1130.01.F.

A.R.S. § 43-1122.19 provides a subtraction for the amount by which a capital loss carryover allowable pursuant to A.R.S. § 43-1130.01.F exceeds the capital loss carryover allowable pursuant to I.R.C. § 1341(b)(5).

A.R.S. § 43-1130.01 provides for the computation of the Arizona income tax where a taxpayer restores a substantial amount held under a claim of right.

I.R.C. § 1341 provides for the computation of the federal income tax where a taxpayer restores a substantial amount held under a claim of right.

DISCUSSION:

Generally, under the claim of right doctrine, a taxpayer must include in gross income any income to which the taxpayer has an apparent unrestricted right. Such income must be included in the year received even though the taxpayer may be required to repay that income in a later taxable year.

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.

The Arizona provisions are different from the federal provisions.

For Arizona income tax purposes, the taxpayer may not take a deduction, but must claim a "credit" for the Arizona tax paid for the prior year that was attributable to the inclusion of the repaid amount. When the taxpayer has taken a deduction for federal income tax purposes, the taxpayer must add the amount deducted to its Arizona gross income.

In the case of a cash basis taxpayer, the provisions of A.R.S. § 43-1130.01 apply to the taxable year in which the item of income included in a prior year under a claim of right is actually repaid. In the case of an accrual basis taxpayer, the provisions of A.R.S. § 43-1130.01 apply to the taxable year in which the obligation for the repayment of the item included in a prior year under a claim of right properly accrues.

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.

PROCEDURE:

Requirements

A corporation must compute its Arizona income tax under A.R.S. § 43-1130.01 when:

1. 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.

2. 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.

3. 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.

4. The amount of the deduction exceeds $3,000.

The Arizona provision does not apply to any deduction that is allowable with respect to:

1. an item that was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer; or

2. 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

3. property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

These exceptions to the relief provisions do not apply to payments or refunds of a regulated public utility as described in A.R.S. § 43-1130.01.D

Tax Computation

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 following examples will illustrate how a taxpayer computes the decrease in tax for a prior taxable year (or years).

Example (1):

Facts:

For the taxable year 1993, a corporation had Arizona taxable income of $35,000 consisting entirely of sales commissions on which it paid Arizona income tax of $3,255 (there were no tax credits for the year). In 1995, it was determined that the commissions were erroneously computed for 1993. Accordingly, the taxpayer pays back $10,000 of the commissions.

The taxpayer's taxable income for 1995, without regard to the $10,000 repayment, was $12,000. The tax on $12,000 is $1,080. Therefore, the taxpayer enters $1,080 on its 1995 Arizona income tax return on the line for computing the 1995 tax.

Under A.R.S. § 43-1130.01, this taxpayer computes the decrease in tax for 1993 as follows:

Tax paid in 1993 on $35,000 $3,255

Tax payable in 1993 on $25,000 $2,325

Decrease in prior year's tax $930

The $930 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1995 and is shown as a tax payment on the 1995 tax return. The taxpayer writes "A.R.S. § 43-1130.01 - $930" next to the space on the 1995 Arizona corporate income tax return on which the taxpayer enters the total of its 1995 tax payments. The taxpayer includes the $930 in the total entered on that line. Therefore, the difference of $150 ($1,080 - $930) is the total tax due for 1995.

The taxpayer also attaches a schedule explaining the amounts restored and the computation of the prior year's tax reduction to its 1995 tax return.

Example (2):

Facts:

For the taxable year 1990, 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 $6,975 (there were no tax credits for the year).

In taxable year 1995, the taxpayer is required to restore the $90,000 capital gain. The taxpayer's taxable income for 1995, without regard to the $90,000 repayment, was $50,000.

Due to the restoration of the 1990 capital gain, this taxpayer has a $30,000 capital loss for the 1990 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 1990 to which the loss could be carried back, capital gains of $5,000 in years 1991 and 1994, 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 (1991 and 1994). 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 1991, 1992, and 1993, the taxpayer had taxable income of $40,000. For each of these years, the taxpayer's Arizona income tax was $3,720. For 1994, the taxpayer also had taxable income of $40,000, with an Arizona income tax of $3,600.

The taxpayer will compute the 1995 tax as follows:

Tax on $50,000 $4,500

Therefore, the taxpayer enters $4,500 on its 1995 Arizona income tax return on the line for computing the 1995 tax.

Under A.R.S. § 43-1130.01, this taxpayer computes the decrease in tax for 1990, 1991, and 1994, as follows (1992 and 1993 remain unchanged since there was no capital gain):

Tax paid in 1990 on $75,000 $ 6,975

Tax payable in 1990 on $15,000 1,395 5,580

Tax paid in 1991 on $40,000 $3,720

Tax payable in 1991 on$35,000 3,255 465

Tax paid in 1994 on $40,000$ 3,600

Tax payable in 1994 on $35,000 3,150 450

Decrease in prior years' tax $ 6,495

The $6,495 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1995 and is shown as a tax payment on the 1995 tax return. The taxpayer writes "A.R.S. § 43-1130.01 - $6,495" next to the space on the 1995 Arizona corporate income tax return on which the taxpayer enters the total of its 1995 tax payments. The taxpayer includes the $6,495 in the total entered on that line. Therefore, the excess of $1,995 ($6,495 - $4,500) may be refunded to the taxpayer.

The taxpayer also attaches a schedule explaining the amounts restored and the computation of the prior years' tax reduction to its 1995 tax return.

Harold Scott, Director

Signed: July 27, 1995

Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to department personnel. A tax procedure is a written statement issued by the department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 92-1 for more detailed information regarding documents issued by the Department of Revenue.