ARIZONA DEPARTMENT OF REVENUE

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ARIZONA INDIVIDUAL INCOME TAX PROCEDURE
ITP 95-1

Procedure for Individuals Who Restore Substantial Amounts Held Under a Claim of Right

(On 11/1/2012 the references to A.R.S. §§ 43-1021.23 and 43-1021.24 were updated to A.R.S. §§ 43-1021.20 and 43-1021.21 due to renumbering of the paragraphs. No substantive changes were made.)

ISSUE:

How does an individual who restores a substantial amount held under a claim of right compute his or her Arizona income tax liability for the year in which the amounts are restored (repaid)?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-1001.1 provides that the Arizona adjusted gross income of a resident individual is the federal adjusted gross income subject to the modifications specified in A.R.S. §§ 43-1021 and 43-1022.

A.R.S. § 43-1021.20 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. § 43-1021.21 requires an addition for the amount by which a net operating loss carryover or capital loss carryover allowable pursuant to I.R.C. § 1341(b)(5) exceeds the net operating loss carryover or capital loss carryover allowable pursuant to A.R.S. § 43-1029.F.

A.R.S. § 43-1022.23 provides a subtraction for the amount by which a net operating loss carryover or capital loss carryover allowable pursuant to A.R.S. § 43-1029.F exceeds the

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net operating loss carryover or capital loss carryover allowable pursuant to I.R.C. § 1341(b)(5).

A.R.S. § 43-1029 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 his or her Arizona gross income.

In the case of a cash basis taxpayer, the provisions of A.R.S. § 43-1029 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. § 43-1029 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

An individual must compute his or her Arizona income tax under A.R.S. § 43-1029 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.

Tax Computation

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 his 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, he or she 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 single individual had Arizona taxable income of $35,000 consisting entirely of sales commissions on which he paid Arizona income tax of $1,565 (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 $405. Therefore, the taxpayer enters $405 on his 1995 Arizona income tax return on the line for computing the 1995 tax.

Under A.R.S. § 43-1029, this taxpayer computes the decrease in tax for 1993 as follows:

Tax paid in 1993 on $35,000	$ 1,565
Tax payable in 1993 on $25,000	1,040
Decrease in prior year's tax	$ 525

The $525 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. § 43-1029 - $525" next to the space on the 1995 Arizona individual income tax return on which the taxpayer enters the total of his 1995 tax payments (i.e., Arizona withholding, estimated tax payments, and extension payments). The taxpayer includes the $525 in the total entered on that line. Therefore, the excess of $120 ($525 - $405) may be refunded to the taxpayer.

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

Example (2):

Facts:

For the taxable year 1990, 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 $3,328 (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, he must compute a tax decrease for taxable years 1991, 1992, 1993, and 1994. (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 (1990, 1991, 1992, 1993, and 1994) and $3,000 to the current taxable year

(1995). The remaining $12,000 of capital loss must be carried forward and utilized for taxable year 1996 and succeeding taxable years.

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 $1,828. For 1994, the taxpayer also had taxable income of $40,000, with an Arizona income tax of $1,683.

Since the taxpayer will apply $3,000 of the capital loss carryover to 1995, the taxpayer will compute the 1995 tax, as follows:

Tax (using 1995 tax table X) on $47,000 ($50,000 less $3,000 1990 capital loss carryover)	$ 1,749

Therefore, the taxpayer enters $1,749 on his 1995 Arizona income tax return on the line for computing the 1995 tax.

Under A.R.S. § 43-1029, this taxpayer computes the decrease in tax for 1990, 1991, 1992, 1993, and 1994, as follows:

Tax paid in 1990 on $65,000	$ 3,328	
Tax payable in 1990 on $2,000 ($15,000 ordinary income, less $3,000 capital loss, less $10,000 personal exemption and standard deduction)	76	3,252
Tax paid in 1991 on $40,000	$ 1,828	
Tax payable in 1991 on $37,000	1,670	158
Tax paid in 1992 on $40,000	$ 1,828	
Tax payable in 1992 on $37,000	1,670	158
Tax paid in 1993 on $40,000	$ 1,828	
Tax payable in 1993 on $37,000	1,670	158
Tax paid in 1994 on $40,000	$ 1,683	
Tax payable in 1994 on $37,000	1,531	152
Decrease in prior years' tax		$ 3,878

> The $3,878 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. § 43-1029 - $3,878" next to the space on the 1995 Arizona individual income tax return on which the taxpayer enters the total of his 1995 tax payments (i.e., Arizona withholding, estimated tax payments, and extension payments). The taxpayer includes the $3,878 in the total entered on that line. Therefore, the excess of $2,129 ($3,878 - $1,749) 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 his 1995 tax return.

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Harold Scott, Director

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Date

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.