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ARIZONA CORPORATE TAX PROCEDURE
CTP 02-1

Procedure for Determining Whether a Domestic Corporation
Should be Treated as a Foreign Corporation
for Arizona Income Tax Purposes

ISSUE:

When is a domestic corporation treated as a foreign corporation for Arizona income tax purposes?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-1101(3) defines a domestic corporation as a corporation created or organized in the United States or under the laws of the United States or of any state of the United States or the District of Columbia.

A.R.S. § 43-1101(5)(b) defines a foreign corporation as "a domestic corporation with less than twenty per cent of its property, payroll and sales in the United States for the three year period ending with the close of the taxable year of the corporation preceding the current taxable year, or for such part of that period as the corporation has been in existence." This definition applies to taxable years beginning from and after December 31, 1989.

A.R.S. §§ 43-1140 through 43-1147 define the property, payroll, and sales factors as they apply to apportioning income to Arizona.

DISCUSSION:

A domestic corporation is considered a foreign (80/20) corporation for Arizona tax purposes if less than 20 percent of its business activity is within the United States. This percentage is measured by the corporation's property, payroll, and sales in the United States for the three-year period preceding the current taxable year. If the average percentage for the three-year period is below 20 percent then the corporation is considered a foreign corporation for Arizona tax purposes. This computation is consistent with the underlying purpose of the 80/20 rule, which is to exclude from apportionment only those corporations engaged primarily in business activities outside the United States.

The following examples illustrate the calculations for determining whether a domestic corporation is foreign with respect to the 80/20 rule defined in A.R.S. § 43-1101(5)(b).

Example 1:

Corporation B is a domestic corporation that has business activity within and without the United States. To determine whether Corporation B is a foreign corporation as defined in A.R.S. § 43-1101(5)(b) for the calendar year ending 12/31/97, the following information needs to be analyzed.

** Property is the average of the beginning and ending balances for the taxable year.

U.S. FACTORS[1]

	1994	1995	1996
Payroll	100	200	300
Property**	200	300	400
Sales	500	600	700

WORLDWIDE FACTORS[1]

	1994	1995	1996
Payroll	500	600	700
Property**	1000	1100	1200
Sales	2000	2100	2200

PERCENTAGE OF U.S. DIVIDED BY WORLDWIDE

	1994	1995	1996	Average of %
Payroll	20.0%	33.3%	42.9%	
Property**	20.0%	27.3%	33.3%	
Sales	25.0%	28.6%	31.8%	
Average[2]	21.7%	29.7%	36.0%	29.1%

Answer:

Corporation B's U.S. business activity is calculated by dividing the total percentages for payroll, property, and sales for the three-year period by 3. [87.4% / 3 = **29.1%**] The 87.4% is computed by adding 21.7%+29.7%+36% averages for tax years 1994-1996. Corporation B is **not** a foreign corporation under Arizona tax law for tax year ending 12/31/97, since Corporation B's business activity in the United States is greater than 20% for the testing period.

Example 2:

Corporation B started business activity in 1997. Is Corporation B considered a foreign or domestic corporation based on the following 1997 financial factors?

** Property is the average of the beginning and ending balances for the taxable year.

U.S. FACTORS[1]

	1997
Payroll	100
Property**	250
Sales	500

WORLDWIDE FACTORS[1]

	1997
Payroll	2000
Property**	4500
Sales	9000

PERCENTAGE OF U.S. DIVIDED BY WORLDWIDE

	1997
Payroll	5.0%
Property**	5.6%
Sales	5.6%

Average [2]	5.4%

Answer:

Corporation B's U.S. business activity is measured by dividing 16.2% by 3, which equals **5.4%**. The 16.2% is computed by adding 5%+5.6%+5.6% for the tax years 1997.

Corporation B is a foreign corporation under Arizona tax law for taxable year ending 12/31/97, because Corporation B's business activity in the United States is less than 20% for the testing period. In this example, the testing period is that part of the three-year period that Corporation B was in existence, which is 1997. If Corporation B had business activity in 1996 and 1997, then only the 1996 factors would be used to determine the percentage of U.S. activity for the 1997 taxable year.

Example 3:

If Corporation B did not have payroll or property for 1994, 1995, or 1996, is Corporation B considered a foreign or domestic corporation?

** Property is the average of the beginning and ending balances for the taxable year.

U.S. FACTORS[1]

	1994	1995	1996
Payroll	0	0	0
Property**	0	0	0
Sales	500	600	700

WORLDWIDE FACTORS[1]

	1994	1995	1996
Payroll	0	0	0
Property**	0	0	0
Sales	2000	2100	2200

PERCENTAGE OF U.S. DIVIDED BY WORLDWIDE

	1994	1995	1996	Average of %
Payroll	N/A	N/A	N/A	
Property**	N/A	N/A	N/A	
Sales	25.0%	28.6%	31.8%	
Average [2]	25.0%	28.6%	31.8%	28.5%

Answer:

Corporation B's U.S. business activity is measured by dividing 85.4% by 3, which equals **28.5%**. The 85.4% is computed by adding 25%+28.6%+31.8% averages for tax years 1994-1996. Corporation B is **NOT** a foreign corporation under Arizona tax law for tax year ending 12/31/97, because Corporation B's business activity in the United States is more than 20% for the testing period. Corporation B did not have any property or payroll in the United States or Worldwide. Therefore, the denominator is one and not three when computing the apportionment ratio for each year.

Example 4:

Corporation B is a domestic corporation that has business activity within and without the United States. To determine whether Corporation B is a foreign corporation as defined in A.R.S. § 43-1101(5)(b) for the calendar year ending 12/31/97, the following information needs to be analyzed.

** Property is the average of the beginning and ending balances for the taxable year.

U.S. FACTORS[1]

	1994	1995	1996
Payroll	0	0	500
Property**	10	0	400
Sales	200	200	700

WORLDWIDE FACTORS[1]

	1994	1995	1996
Payroll	0	0	2100
Property**	500	600	2000
Sales	600	1000	2200

PERCENTAGE OF U.S. DIVIDED BY WORLDWIDE

	1994	1995	1996	Average of %
Payroll	N/A	N/A	23.8%	
Property**	2.0%	0%	20.0%	
Sales	33.3%	20.0%	31.8%	
Average[2]	17.7%	10.0%	25.2%	17.6%

Answer:

Corporation B's U.S. business activity is measured by dividing 52.9% (total apportionment ratios from all three years) by 3, which equals **17.6%**. The 52.9% is computed by adding 17.7%+10%+25.2% averages for tax years 1994-1996. Corporation B is a foreign corporation under Arizona tax law for tax year ending 12/31/97, because Corporation B's business activity in the United States is less than 20% for the testing period. The denominator of the apportionment ratio computation for each year is the same as the number of factors with activity.

CONCLUSION:

The determination of whether a domestic corporation is treated as foreign under A.R.S. § 43-1101(5) is made on the basis of the simple average of the corporation's property, payroll, and sales factors (based on U.S. to Worldwide property, payroll, and sales) for the prior three-year period (testing period) without regard to any weighting of those factors. If a corporation is not in existence for the entire prior three-year period, taxpayers shall use the fractional part of the period they were in existence. When a corporation does not have one or more of the apportionment factors in **both** the United States and Worldwide for a taxable year: 1) the absent factor(s) is (are) not included in computing the factor(s) average(s) for the taxable year; and 2) the denominator in computing the year average is the number of factors remaining for that year. When a corporation does not have one or more factors in **both** the United States and Worldwide for the **entire** three year or other applicable period: 1) the factor(s) is (are) entirely removed from the calculation; and 2) the denominator in computing the period average is the number of remaining factors for that year.

[1] The payroll, property, and sales are computed in a manner similar to the apportionment factor definitions outlined in A.R.S. §§ 43-1140 through 43-1147, the United States is substituted for Arizona and the numerator of the sales factor would include all sales of tangible personal property shipped to or delivered within the U.S. including sales to the U.S. Government. The purpose of the computation is to determine the percentage of activity outside the U.S. and not to apportion Arizona income, therefore, the factors could include federal income that may not taxable for Arizona purposes.

[2] The average is computed by adding the total percentages for payroll, property, and sales and dividing by the number of factors used. For example, if there was no payroll in the U.S. and Worldwide (and there was property and sales) then the denominator would be two. If there was no payroll in the U.S. but some in Worldwide (and there was property and sales) then the denominator is three. In order to drop one of the factors in the denominator there needs to be no activity in both the U.S. and Worldwide.

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Mark W. Killian, 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 96-1 for more detailed information regarding documents issued by the Department of Revenue.