ARIZONA DEPARTMENT OF REVENUE

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ARIZONA CORPORATE TAX RULING
CTR 93-10

(On November 23, 2012 the citations to Arizona Administrative Code rules were updated. See the footnotes for details. No substantive changes were made.)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUES:

1. What are the apportionment factor representation and allocation requirements for a corporation whose only connection with Arizona is its partnership interest in a partnership that is a partner in a tiered partnership?

2. What are the apportionment factor representation and allocation requirements for a corporation that has business activities within and without Arizona in addition to its partnership interest in a partnership that is a partner in a tiered partnership?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-1131.1[1] defines "business income" to mean income arising from transactions and activity in the regular course of the taxpayer's trade or business.

A.R.S. § 43-1139 states that all business income shall be apportioned to this state by use of a three-factor formula consisting of a property factor, payroll factor, and sales factor.

A.R.S. § 43-1131.4 defines "nonbusiness income" to mean all income other than business income.

A.A.C. R15-2D-101[2] defines "allocation" as the assignment of nonbusiness income to a particular state.

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[1] The definition of "business income" in former A.A.C. R15-2-1131.A was removed from the rules because it simply repeated the definition that was already in A.R.S. § 43-1131.1. Therefore, the reference to the rule was removed from this ruling. No substantive change was made.

[2] When the ruling was issued the citation was to A.A.C. 15-2-1131.A which has since been renumbered to R15-2D-101. No substantive change was made.

A.R.S. § 43-1412.17 requires that each partner include its distributive share of the partnership's Arizona taxable income in the computation of the taxable income of the partner.

Treasury Regulation (Treas. Reg.) § 1.704-1(b)(1) provides, in general, that income of a partnership will be distributed to the partners based on their respective interests in the partnership.

DISCUSSION:

For the purposes of this tax ruling, a "tiered partnership" is defined as a partnership whose partners are partnerships.

A tiered **business** partnership's apportionment factor representation would reflect both the operating partner's Arizona activity and the partner's interest in the operating partnership, assuming that the operating partnership has nexus with Arizona.

The allocation of a tiered **nonbusiness** partnership's income or loss would reflect the corporation's ultimate distributive share of the tiered partnership's Arizona activities.

Issue 1:

What are the apportionment factor representation and allocation requirements for a corporation whose only connection with Arizona is its partnership interest in a partnership that is a partner in a tiered partnership?

Example:

Partnership A has active operations in Arizona that provide a 50% apportionment ratio. The 50% ratio accurately reflects all three (property, payroll, and sales) of the factors that comprise the ratio. Partnership B holds a 25% interest in Partnership A. Corporation C holds a 10% interest in Partnership B. **Partnership B and Corporation C do not have any connection with Arizona other than these partnership interests.**

Corporation C must report its income or loss from the partnership based on its ultimate distributive share of Partnership A's Arizona income, loss, gain, and other items. Corporation C would report on the apportionment basis if its partnership interest is business or by making an allocation if its partnership interest is nonbusiness.

If Corporation C's 10% interest in Partnership B is **business**, Corporation C would include 1.25% of Partnership A's property, payroll, and sales in the numerator of its apportionment ratio. The numerator is determined as follows: (50% Arizona activity x 25% Partnership B's interest in the operating partnership) x 10% partnership interest of Corporation C. The denominator of Corporation C's apportionment ratio would include 2.5% of Partnership A's property, payroll, and sales as well as the appropriate amount of Corporation C's total property, payroll, and sales. The denominator is determined by multiplying Corporation C's 10% partnership interest by Partnership B's 25% interest in the operating partnership.

If Corporation C's 10% interest in Partnership B is **nonbusiness**, Corporation C must allocate its distributive share of Partnership B's income or loss to Arizona. Corporation C's distributive share would be determined as follows: (50% Arizona activity x 25% Partnership B's interest in the operating partnership) x 10% partnership interest of Corporation C = 1.25%. In this case, Corporation C would **not** be given apportionment factor representation for its distributive share of Partnership A's property, payroll, and sales in either the numerator or denominator of its apportionment ratio.

<u>RULING</u>:

A corporation that does not have any connection with Arizona, other than a partnership interest in a partnership that is a partner in a tiered partnership, must apportion or allocate its ultimate distributive share of the tiered partnership's income or loss from Arizona activities.

If the corporation's interest in the tiered partnership is **business**, the numerator and denominator of the corporation's apportionment factors in the Arizona tax return would include the corporation's distributive share of the tiered partnership's factors.

The allocation of a tiered **nonbusiness** partnership's income or loss in the corporation's Arizona tax return would reflect the corporation's ultimate distributive share of the tiered partnership's Arizona activities.

Issue 2:

What are the apportionment factor representation and allocation requirements for a corporation that has business activities within and without Arizona in addition to its partnership interest in a tiered partnership?

A multistate corporation that has business activities within and without Arizona would apportion its income from such activities by means of a three-factor formula consisting of property, payroll, and sales.

Example:

Partnership A has active operations in Arizona that provide a 50% apportionment ratio. The 50% ratio accurately reflects all three (property, payroll, and sales) of the factors that comprise the ratio. Partnership B holds a 25% interest in Partnership A. Corporation C holds a 10% interest in Partnership B. Partnership B does not have any connection with Arizona other than its partnership interest. **Corporation C has business activities within and without Arizona in addition to its partnership interest in a partnership that is a partner in a tiered partnership.**

Corporation C must apportion its income from business activities within and without Arizona. The numerator of the apportionment ratio will include the appropriate amount of the corporation's Arizona property, payroll, and sales related to its business activities. The denominator of the apportionment ratio will include the appropriate amount of the corporation's total property, payroll, and sales related to its business activities.

Corporation C must also report its income or loss from the partnership based on its ultimate distributive share of Partnership A's Arizona income, loss, gain and other items. Corporation C would report on the apportionment basis if its partnership interest is business or by making an allocation if its partnership interest is nonbusiness.

If Corporation C's 10% interest in Partnership B is **business**, Corporation C would include 1.25% of Partnership A's property, payroll, and sales in the numerator of its apportionment ratio. The numerator is determined as follows: (50% Arizona activity x 25% Partnership B's interest in the operating partnership) x 10% partnership interest of Corporation C. The denominator of Corporation C's apportionment ratio would include 2.5% of Partnership A's property, payroll, and sales. The denominator is determined by multiplying Corporation C's 10% partnership interest x Partnership B's 25% interest in the operating partnership. The corporation's apportionment ratio would also include the previously determined appropriate amounts of the corporation's property, payroll, and sales related to its business activities within and without Arizona.

If Corporation C's 10% interest in Partnership B is **nonbusiness**, Corporation C must allocate its distributive share of Partnership B's income or loss to Arizona. Corporation C's distributive share in Partnership B would be calculated as follows: (50% Arizona activity x 25% Partnership B's interest in the operating partnership) x 10% partnership interest of Corporation C = 1.25%. In this case, Corporation C would **not** be given apportionment factor representation for its distributive share of Partnership A's property, payroll, and sales in either the numerator or denominator of its apportionment ratio.

RULING:

A multistate corporation that has business activities within and without Arizona must apportion its income from such activities in addition to the apportionment or allocation of its ultimate distributive share of the tiered partnership's income or loss from Arizona activities.

If the corporation's interest in the tiered partnership is **business**, the numerator and denominator of the corporation's apportionment factors in the Arizona tax return would include the corporation's distributive share of the tiered partnership's factors.

The allocation of a tiered **nonbusiness** partnership's income or loss in the corporation's Arizona tax return would reflect the corporation's ultimate distributive share of the tiered partnership's Arizona activities.

(See CTR 93-9 for additional information on tiered partnerships.)

Harold Scott, Director

Signed: April 30,1993

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law which are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement which provides interpretation, details or supplementary information concerning the application of the law. **Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling**. See GTP 92-1 for more detailed information regarding documents issued by the Department of Revenue.