ARIZONA DEPARTMENT OF REVENUE

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ARIZONA CORPORATE TAX RULING
CTR 94-2

(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 filing requirements for a corporate partner of an Arizona partnership?

2. What apportionment factor representation is given for corporate partners of an Arizona 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.A.C. R15-2D-101[2] defines a "unitary business."

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

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

A.A.C. R15-2D-101[3] defines "allocation" as the assignment of nonbusiness income to a particular state.

A.R.S. § 43-1412 provides for the computation of the taxable income of the partners of a partnership.

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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 definition of "unitary business" was in A.A.C. R15-2-1131.E, it is now located in A.A.C. R15-2D-101.

[3] 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.

Internal Revenue Code (I.R.C.) § 704(b) and Treasury Regulation (Treas. Reg.) § 1.704-1(b)(1) provide, in general, that income of a partnership will be distributed to the partners based on their respective interests in the partnership.

I.R.C. § 702(b) and Treas. Reg. § 1.702-1(b) address the conduit or pass-through treatment of income, loss, gain, and other items to the partners.

A.R.S. § 43-1132.A provides that any taxpayer, other than a foreign corporation which is not itself subject to tax, having income from business activity which is taxable both within and without this state shall allocate and apportion its net income.

<u>DISCUSSION</u>:

Issue 1:

What are the filing requirements for a corporate partner of an Arizona partnership?

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

The underlying basis for requiring the corporate partner to report its income or loss from the partnership is that the partnership's <u>business</u> <u>activity</u> in Arizona requires the partner to either apportion or allocate its distributive share of the partnership's income or loss.

A corporation would be required to report its distributive share of the partnership's income or loss even if the only connection with Arizona is its interest in the Arizona partnership.

<u>Examples</u>:

1. Corporation A is domiciled in Los Angeles, California and holds a 25 percent interest in the profit, loss, and capital of Arizona Partnership B, which is formed and domiciled in Arizona. Corporation A's only connection with Arizona is being a partner in Partnership B. Since Partnership B is conducting business in Arizona, Corporation A must file an Arizona corporate income tax return reporting its distributive share of Partnership B's Arizona income or loss. Corporation A would apportion its distributive share of Partnership B's income or loss if its partnership interest is business or make an allocation if its partnership interest is nonbusiness.

2. Corporation A has business activity within and without Arizona in addition to holding a 25 percent interest in the profit, loss, and capital of Partnership B. Corporation A must file an Arizona corporate income tax return apportioning its income from business activities within and without Arizona. It must also report its income or loss from the partnership based on its distributive share of Partnership B's Arizona income or loss. Corporation A would apportion its distributive share of Partnership B's income or loss if its partnership interest is business or make an allocation if its partnership interest is nonbusiness.

Issue 2:

What apportionment factor representation is given for corporate partners of an Arizona partnership?

The critical element in determining whether apportionment factor representation is given to the corporate partner is whether or not the partnership income is business income or nonbusiness income. Business income arises from transactions and activities in the regular course of the corporate partner's trade or business. All other income is nonbusiness income.

If a corporate partner's distributive share of its partnership income is included in business income on an apportionment basis, then its proportionate share of the partnership's property, payroll, and sales should be included in the appropriate factors in determining the apportionment ratio of the corporate partner.

A determination that its partnership income is nonbusiness would require the corporate partner to allocate its distributive share of the partnership's Arizona income or loss. In this situation, apportionment factor representation would not be given to the corporate partner for its share of the partnership's property, payroll, or sales.

Examples:

1. Corporation A is domiciled in New Jersey and holds a 10 percent interest in the profit, loss, and capital of Arizona Partnership B, which is formed, domiciled, and operates 100 percent in Arizona. Corporation A's only connection with Arizona is being a partner in Partnership B.

   If Corporation A's partnership interest in Partnership B is business, Corporation A would file an apportionment return to Arizona. Corporation A would include 10 percent of Partnership B's property, payroll, and sales in the numerator and denominator of its apportionment ratio. Corporation A would include its distributive share of Partnership B's income or loss in its apportionable income.

   If Corporation A's interest in Partnership B is nonbusiness, Corporation A would allocate to Arizona its distributive share of Partnership B's income or loss. In this situation, apportionment factor representation would not be given to Corporation A for Partnership B's property, payroll, or sales.

2. Corporation A has business activity within and without Arizona in addition to holding a 25 percent interest in the profit, loss, and capital of Partnership B. Partnership B has an Arizona apportionment ratio of 50 percent. Corporation A files an Arizona corporate income tax return apportioning its income from business activities within and without Arizona.

   If Corporation A's partnership interest in Partnership B is business, Corporation A would include 25 percent of Partnership B's **Arizona** property, payroll, and sales (Partnership B's numerator) in its numerator and 25 percent of Partnership B's **total** property, payroll, and sales (Partnership B's denominator) in its denominator for the apportionment ratio. Corporation A would include its distributive share of Partnership B's income or loss in its apportionable income.

If Corporation A's interest in Partnership B is nonbusiness, Corporation A would allocate its distributive share of Partnership B's income or loss. Fifty percent of Corporation A's distributive share, which is the Arizona portion, would be allocated to Arizona. In this situation, apportionment factor representation would <u>not</u> be given to Corporation A for Partnership B's property, payroll, or sales.

<u>RULING</u>:

1. A corporation that has an interest in an Arizona partnership is required to file an Arizona corporate income tax return either apportioning or allocating its distributive share of the partnership's income or loss from Arizona activities.

2. If a corporate partner's distributive share of its partnership income is determined to be business income, i.e., it arises from transactions and activities in the regular course of the corporate partner's trade or business, its proportionate share of the partnership's property, payroll, and sales should be included in the appropriate factors in determining the apportionment ratio of the corporate partner. When a corporate partner's distributive share of its partnership income is determined to be nonbusiness, the corporate partner is required to allocate this amount and apportionment factor representation would not be given to the corporate partner for the partnership's property, payroll, or sales.

See CTR 94-1 for additional information pertaining to reporting by corporate partners.

Harold Scott, Director

Signed: April 4, 1994

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.