



Janice K. Brewer
Governor

David Raber
Acting Director

ARIZONA INDIVIDUAL INCOME TAX RULING ITR 13-5

(Supersedes ITR 99-2 and applies to the use of any net operating loss in any taxable year beginning from and after December 31, 2013, and to any net operating loss created in any taxable year beginning from and after December 31, 2013, even if that loss is carried back to a prior taxable year.)

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.

ISSUE:

Can an individual include a federal net operating loss (NOL) incurred from non-Arizona sources while the taxpayer was an Arizona nonresident, in the Arizona taxable income of a return filed for a taxable year in which the taxpayer is an Arizona resident?

RULING:

An individual cannot include a federal NOL deduction incurred from non-Arizona sources while the taxpayer was an Arizona nonresident, in the Arizona taxable income of a return filed for a taxable year in which the taxpayer is an Arizona resident.

Arizona Treatment for Taxable Year in Which Taxpayer Becomes an Arizona Resident

For the return filed for the year in which a taxpayer becomes an Arizona resident, the taxpayer must exclude, from Arizona income, any NOLs from non-Arizona sources accrued prior to becoming an Arizona resident.

Arizona Treatment for Taxable Year in Which Taxpayer Becomes an Arizona Nonresident

For the return filed for the year in which a taxpayer becomes an Arizona nonresident, the taxpayer must exclude, from Arizona income, any NOLs from non-Arizona sources accrued after becoming an Arizona nonresident.

Arizona Treatment for Taxable Year in Which Taxpayer is a Full-Year Arizona Resident

For a non-Arizona source loss incurred while the taxpayer was an Arizona nonresident, the taxpayer would not be allowed to amend a prior year resident Arizona income tax return to

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 13-5

(Supersedes ITR 99-2)

Page 2

claim the NOL carry back deduction. In the case of a deduction for a carryover from such a NOL, the taxpayer must make an addition to Arizona gross income on the full-year Arizona resident return for the amount of the NOL deduction included in the taxpayer's federal adjusted gross income.

Example:

During 2013, Taxpayer A incurs a federal NOL of \$75,000 from non-Arizona sources. During 2013, Taxpayer A was an Arizona nonresident for the entire taxable year. Taxpayer A becomes an Arizona resident on January 1, 2014. Taxpayer A elects to carry the NOL forward for federal income tax purposes. When Taxpayer A files the 2014 federal income tax return, the federal adjusted gross income on that return, includes a NOL deduction of \$75,000.

2014 Federal Form 1040	
Wages	65,000
Schedule C income	25,000
Other income (net operating loss deduction incurred during 2013)	<75,000>
Federal Adjusted Gross income	15,000

2014 Arizona Form 1040	
Federal Adjusted Gross income	15,000
Additions to income	75,000
Arizona adjusted gross income	90,000

When Taxpayer A files his 2014 full-year Arizona income tax return, Taxpayer A will start that return with his federal adjusted gross income of \$15,000 (which includes the NOL of \$75,000). However, because the NOL was incurred from non-Arizona sources before Taxpayer A became an Arizona resident, Taxpayer A must make an addition to Arizona gross income for \$75,000 (the amount of that NOL included in the 2014 federal adjusted gross income).

DISCUSSION:

Arizona's individual NOL treatment conforms to the federal NOL provisions since the starting point for the Arizona income tax computation is the federal adjusted gross income.

In the case of an individual who changes from a nonresident to a resident, the starting point for the Arizona income tax computation is that portion of the federal adjusted gross income which was earned or accrued during the portion of the year in which the individual was an Arizona resident. However, in a taxable year in which a taxpayer becomes an Arizona resident, A.R.S. § 43-1097, limits deductions to only those deductions realized or

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 13-5

(Supersedes ITR 99-2)

Page 3

recognized during the period the individual was a resident and all deductions related to Arizona source income.

In the case of a full-year Arizona resident, the starting point is the federal adjusted gross income. If that individual has a NOL deduction included in his or her federal adjusted gross income, that deduction will also be included in Arizona gross income. However, A.R.S. § 43-961(5) precludes a taxpayer from taking deductions that are otherwise allowable when the deductions are allocable to a class of income that is not required to be included in the taxpayer's Arizona adjusted gross income or Arizona taxable income. Therefore, deductions allocable to income not subject to Arizona income tax may not be taken on an income tax return.

For years prior to 1999, the department treated net operating losses similar to the method required under this ruling. Beginning with taxable year 1999, the department changed its position and determined that generally A.R.S. § 43-961(5) does not require an add back of a federal NOL carryover incurred from non-Arizona sources prior to residency. However, after reviewing cases that interpreted a similar federal provision (Internal Revenue Code § 265), as well as various Arizona Board of Tax Appeals decisions, the department determined that its pre 1999 position was correct.

For the purpose of the application of A.R.S. § 43-961(5), income earned while a nonresident from non-Arizona sources is a class of income not subject to Arizona income tax. Therefore, in the case of a NOL that was incurred from non-Arizona sources while the individual was an Arizona nonresident, any deduction allowed for federal income tax purposes for that NOL would be allocable to income not subject to Arizona income tax.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-961(5) disallows deductions that are otherwise allowable when the deductions are allocable to a class of income that is not required to be included in the taxpayer's Arizona adjusted gross income or Arizona taxable income.

A.R.S. § 43-1001 provides that the Arizona gross income of a resident individual is the federal adjusted gross income.

A.R.S. § 43-1097 provides for allocation of items of income and deduction in the year in which a taxpayer changes residency status. When a taxpayer changes from a nonresident to a resident, Arizona taxable income includes the income and deductions realized or recognized during the period the individual was a resident and all income and deductions earned in Arizona or derived from Arizona sources prior to residency.

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 13-5

(Supersedes ITR 99-2)

Page 4

I.R.C. § 265, provides in part, that no deduction shall be allowed for expenses otherwise allowable as a deduction which is allocable to one or more classes of income other than interest wholly exempt from federal income taxes.

Arizona State Tax Commission v. Kieckhefer, 67 Ariz. 102, 191 P.2d 729 (1948), held that a right to a deduction does not exist in the absence of statutory authorization and a deduction will not be allowed for items not within the terms of the statute.

Rinehart v. U.S., 429 F.2d 1286 (March 30, 1970) held that a taxpayer was not entitled to a deduction for federal income tax purposes for any Puerto Rican tax paid on income earned in Puerto Rico prior to becoming a U.S. Resident.

Robert and Lou Ann Danielson, Appellants, v. Arizona Department of Revenue, Docket/Court: 1151-94-I, Arizona State Board of Tax Appeals (05/23/1995) held that that the Department properly disallowed the claimed subtraction of federal taxes paid by Appellants on income earned when they were not Arizona residents (A.R.S. § 43-961(5)).

A. Steve and Marcela A. Gurganian, Appellants, v. Arizona Department of Revenue, Docket/Court: 1120-94-I, Arizona State Board of Tax Appeals (08/05/1997) held that taxpayers were not entitled to the deductions claimed in 1985, 1986 and 1987 for federal tax paid for years during which they were not Arizona residents (A.R.S. § 43-961(5)).

John A. and Lanai E. Moore, Appellants, v. Arizona Department of Revenue, Docket/Court: 1746-98-I, Arizona State Board of Tax Appeals (02/09/1999) held that taxpayers were not entitled to deduct net operating losses incurred from non Arizona sources prior to Arizona residency. The deduction was precluded under A.R.S. § 43-961(5).

David Raber, Acting Director

Signed: December 5, 2013

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 that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 13-5

(Supersedes ITR 99-2)

Page 5

statement that provides interpretation, detail, or supplementary information concerning 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 96-1 for more detailed information regarding documents issued by the Department of Revenue.