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ARIZONA INDIVIDUAL INCOME TAX RULING ITR 13-6

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ISSUE:

Can an individual include a capital loss 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?

RULING:

An individual cannot include a capital loss 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. Therefore, a capital loss incurred from non-Arizona sources while the taxpayer was an Arizona nonresident cannot be carried forward to a taxpayer's Arizona resident return when the loss carryover is reflected in the taxpayer's federal adjusted gross income.

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

For the taxable year in which the taxpayer becomes an Arizona resident, Arizona taxable income must reflect all income and deductions realized or recognized, or both, depending on the taxpayer's method of accounting, during the period the individual was a resident, except any income accrued by a cash basis taxpayer prior to the time the taxpayer became a resident of this state. For the return filed for the year in which a taxpayer becomes an Arizona resident, Arizona income would not include capital losses from non-Arizona sources accrued prior to becoming an Arizona resident. Therefore, for the year of change, non-Arizona source capital losses that arose prior to Arizona residency cannot be used to offset capital gains or any other income, that was realized after becoming a resident.

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

In the case of a deduction for a capital loss carryover from a capital loss incurred while the taxpayer was an Arizona nonresident from non-Arizona sources, the taxpayer must make

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 13-6

Page 2

an addition to Arizona gross income on the full-year Arizona resident return for the amount of such capital loss deduction included in the computation of the taxpayer's federal adjusted gross income.

Example:

For federal income tax purposes, Taxpayer B incurs an excess capital loss of \$10,000 from non-Arizona sources during taxable year 2010. During 2010, Taxpayer B was an Arizona nonresident for the entire taxable year. Taxpayer B became an Arizona resident on January 1, 2011. Taxpayer B carries the excess capital loss forward and deducts \$3,000 of that loss on his 2011 federal income tax return.

When Taxpayer B files his 2011 full-year Arizona income tax return, Taxpayer B will start that return with his federal adjusted gross income (which includes the \$3,000 capital loss deduction). Because that \$3,000 capital loss was incurred from non-Arizona sources while Taxpayer B was an Arizona nonresident, Taxpayer B must make an addition to Arizona gross income in the amount of \$3,000.

DISCUSSION:

Arizona's individual capital loss treatment conforms to the federal capital loss 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 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 capital loss carryover 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 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 capital loss that was incurred from non-Arizona sources

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 13-6

Page 3

while the individual was an Arizona nonresident, any deduction allowed for federal income tax purposes for that capital loss 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 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. § 43-1097 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 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.

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 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.