

## ARIZONA CORPORATE TAX RULING

### CTR 95-3

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. Under what circumstances may a taxpayer file an Arizona combined return for a unitary business which includes an S corporation?
2. What portion of the S corporation's income and apportionment factors may be included in an Arizona combined return?

#### **APPLICABLE LAW:**

Arizona Revised Statutes (A.R.S.) § 43-942 provides authority for the Department of Revenue to require the filing of a combined return.

A.R.S. § 43-1126 sets forth the requirements for S corporations in Arizona.

A.R.S. § 43-1132.A provides that the net income of any taxpayer from business activity which is taxable both within and without Arizona shall be allocated and apportioned as provided in the Uniform Division of Income for Tax Purposes Act (UDITPA). The statute further prescribes restrictions on the allocation and apportionment of the net income of a foreign corporation as defined in UDITPA (A.R.S. §§ 43-1131 through 43-1150).

Arizona Administrative Code (A.A.C.) rule R15-2-1131.E defines a unitary business and requires a taxpayer to file a combined return for a unitary business. The administrative rule also provides that the entities comprising the unitary business must be united by a bond of direct or indirect ownership or control of more than 50 percent of the voting stock of a subsidiary corporation.

A.A.C. R15-2-1132.E further defines a combined report and prescribes the methodology for determining the portion of the unitary business's income that is attributable to Arizona.

Internal Revenue Code (I.R.C.) § 1361(a) defines an S corporation as a small business corporation for which an election under I.R.C. § 1362(a) is in effect for the taxable year.

I.R.C. § 1361(b) provides that a small business corporation electing S corporation status may not be a member of an affiliated group as defined in I.R.C. § 1504 and that its shareholders must be individuals, estates, or trusts as described in I.R.C. § 1361(c).

I.R.C. § 1504 defines an affiliated group, in general, as one or more chains of includible corporations connected through stock ownership (possession of 80 percent of the total voting power and total value of the stock) with a common parent corporation.

### **DISCUSSION (Issue 1):**

*Under what circumstances may a taxpayer file an Arizona combined return for a unitary business which includes an S corporation?*

A.A.C. R15-2-1131.E provides that the entities comprising the unitary business group must be united by a bond of **direct or indirect ownership or control of more than 50 percent of the voting stock of a subsidiary corporation**. Thus, there generally must be a parent-subsidiary relationship with more than 50 percent ownership before a unitary business group can exist.

For federal tax purposes, I.R.C. § 1361(b) provides that the shareholders of an S corporation must be individuals, trusts, or estates as defined in I.R.C. § 1361(c). As a result, the S corporation cannot be a subsidiary of another corporation. Therefore, an S corporation cannot be included in a combined return as a subsidiary of a member of the unitary business group.

I.R.C. § 1361(b) prohibits an S corporation from being a member of an affiliated group of corporations as defined in I.R.C. § 1504. I.R.C. § 1504 describes an affiliated group as one or more chains of corporations connected through stock ownership (possession of 80 percent of the total voting power and total value of the stock) with a common parent corporation. However, an S corporation can be a parent corporation provided it owns less than 80 percent of the voting stock of a C corporation. Therefore, if an S corporation owns more than 50 percent but less than 80 percent of the voting stock of a C corporation, the S corporation and the C corporation may qualify to file a combined return assuming they satisfy the other criteria of a unitary business group set forth in A.A.C. R15-2-1131.E.

### **RULING (Issue 1):**

An S corporation may be included in an Arizona combined return for a unitary business. However, the S corporation must be the parent of one or more C corporations and own or control more than 50 percent but less than 80 percent of the voting stock of the C corporations.

## DISCUSSION (Issue 2):

*What portion of the S corporation's income and apportionment factors may be included in an Arizona combined return?*

An S corporation having income from business activity which is taxable both within and without Arizona is subject to the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).

However, an S corporation is only subject to tax (as a corporation) in Arizona to the extent that it is subject to tax at the corporate level for federal income tax purposes. An S corporation, for federal income tax purposes, is subject to tax at the corporate level on excess net passive income and certain capital or built-in gains. Therefore, only a portion of the S corporation's income, i.e., the excess net passive income and certain capital or built-in gains of the S corporation, may be included in the net income of the unitary business group.

The income of the S corporation that is subject to tax, or any portion thereof, must be apportioned if it is **business income** and allocated if it is **nonbusiness income**.

The apportionment factors of the unitary business group would include only a proportionate share of the S corporation's property, payroll, and sales factors. The portion of the S corporation's property, payroll, and sales factors to be included in the apportionment factors of the unitary business group is determined as follows:

1. Divide the S corporation's total excess net passive income and total capital or built-in gains (that are taxable to the S corporation itself) by the total income of the S corporation.
2. Multiply the numerator and denominator of each factor (property, payroll, and sales) of the S corporation by the resulting ratio.
3. Add the computed numerator and denominator of each factor (property, payroll, and sales) of the S corporation to the numerator and denominator of each factor (property, payroll, and sales) of the unitary business group.

### Example:

Corporation A, an S corporation, is the parent of a unitary business group and is required to file an Arizona combined return for the unitary business. Corporation A has total income of \$100,000, which includes \$10,000 of excess net passive income and built-in gains. The income of the unitary business group that is

subject to apportionment and allocation includes the income of Corporation A only to the extent of its excess net passive income and built-in gains (\$10,000).

Corporation A's property factor includes \$10,000 in the numerator and \$50,000 in the denominator. The payroll factor numerator is \$15,000 and the denominator is \$30,000. The numerator of the sales factor is \$10,000 and the denominator is \$200,000.

The proportionate share of Corporation A's property, payroll, and sales factors included in the apportionment factors of the unitary business group is determined as follows:

(1) Total excess net passive income/built-in gains divided by total income (\$10,000/\$100,000) equals 10 percent.

(2) The resulting ratio is applied separately to the numerator and denominator of each factor of Corporation A.

Property factor:  $10\% \times \$ 10,000 = \$ 1,000$  (numerator)  
 $10\% \times \$ 50,000 = \$ 5,000$  (denominator)

Payroll factor:  $10\% \times \$ 15,000 = \$ 1,500$  (numerator)  
 $10\% \times \$ 30,000 = \$ 3,000$  (denominator)

Sales factor:  $10\% \times \$ 10,000 = \$ 1,000$  (numerator)  
 $10\% \times \$ 200,000 = \$ 20,000$  (denominator)

(3) Add the proportionate share of Corporation A's property, payroll, and sales factors to the property, payroll, and sales factors of the unitary business group to compute the apportionment ratio of the unitary business. The amounts of the numerator and denominator of Corporation A's property, payroll, and sales factors to be included in the apportionment factors of the unitary business group are as follows:

Property factor: \$ 1,000 (numerator)  
\$ 5,000 (denominator)

Payroll factor: \$ 1,500 (numerator)  
\$ 3,000 (denominator)

Sales factor: \$ 1,000 (numerator)  
\$ 20,000 (denominator)

## **RULING (Issue 2):**

The income of the unitary business group subject to apportionment and allocation may include only the portion of the S corporation's income that is subject to tax at the corporate level for federal income tax purposes.

The apportionment factors of the unitary business group may include only a proportionate share of the S corporation's property, payroll, and sales factors.

Harold Scott, Director  
Signed: April 11, 1995

### 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.