STATE OF ARIZONA

Department of Revenue

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ARIZONA CORPORATE INCOME TAX PROCEDURE
CTP 16-1

(Supersedes CTP 95-3)

Procedure for Corporations That Restore Substantial Amounts Held Under a Claim of Right

ISSUE:

How does a corporation that restores a substantial amount held under a claim of right compute its Arizona income tax liability for the year in which the amounts are restored (repaid)?

DISCUSSION:

Generally, under the claim of right doctrine, a taxpayer must include in gross income any income to which the taxpayer has an apparent unrestricted right. Such income must be included in the year received even though the taxpayer may be required to repay that income in a later taxable year.

For federal income tax purposes, there are two different methods to compute the tax for the year in which amounts held under a claim of right are required to be repaid. A taxpayer may take a deduction for the repayment of an amount held under a claim of right or claim a "credit." The credit is equal to the amount of tax for the prior year that was attributable to the inclusion of the repaid amount. The taxpayer must use the method that results in the lesser amount of tax.

The Arizona provisions are different from the federal provisions.

For Arizona income tax purposes, the taxpayer may not take a deduction, but must claim a "credit" for the Arizona tax paid for the prior year that was attributable to the inclusion of the repaid amount. When the taxpayer has taken a deduction for federal income tax purposes, the taxpayer must add the amount deducted to its Arizona gross income.

In the case of a cash basis taxpayer, the provisions of Arizona Revised Statutes (A.R.S.) § 43-1130.01 apply to the taxable year in which the item of income included in a prior year under a claim of right is actually repaid. In the case of an accrual basis taxpayer, the provisions of A.R.S. § 43-1130.01 apply to the taxable year in which the obligation for the repayment of the item included in a prior year under a claim of right properly accrues.

Since the adjustment is made for the year of repayment, the return for the prior year in which the income item was received is not reopened and there is no allowance for interest on the tax paid for the earlier year. However, since the restoration will have the effect of negating the income that was included in a prior year under a claim of right, any net operating loss or capital loss that would have existed had the income not been included will be established. Such losses are to be utilized in calculating the tax decrease for the taxable year in which the amounts were included and the tax decrease for taxable years to which the losses could have been carried. Any remaining loss is to be carried forward and applied to taxable years subsequent to the year of restoration.

PROCEDURE:

Requirements

A corporation must compute its Arizona income tax under A.R.S. § 43-1130.01 when:

1. The taxpayer included an item of income in the gross income of a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item.

2. After the close of the prior taxable year (or years) it was established that the taxpayer did not have an unrestricted right to all or part of the item.

3. A deduction for the repayment is allowable under the Internal Revenue Code or Title 43 of the Arizona Revised Statutes. For example, the repayment may constitute a deductible trade or business expense, profit seeking expense, or a deductible loss.

4. The amount of the deduction exceeds $3,000.

The Arizona provision does not apply to any deduction that is allowable with respect to:

1. An item that was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer; or

2. Other property of a kind that would properly have been included in the inventory of the taxpayer on hand at the close of the prior taxable year; or

3. Property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

These exceptions to the relief provisions do not apply to payments or refunds of a regulated public utility as described in A.R.S. § 43-1130.01(D).

Tax Computation

When a taxpayer is required to compute its tax under A.R.S. § 43-1130.01, the Arizona income tax is the tax for the taxable year less the Arizona income tax decrease for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for the prior taxable year (or years).

When computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, the taxpayer must first ascertain the amount of tax previously determined for the taxpayer for such prior taxable year (or years).

The tax previously determined is the sum of the amounts shown by the taxpayer on its return (or returns), plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which appropriately should be assessed or collected, reduced by the amount of any refunds or credits which have previously been made or which appropriately should be made.

After the taxpayer has ascertained the tax previously determined, it must then determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable.

The following examples will illustrate how a taxpayer computes the decrease in tax for a prior taxable year (or years).

Example 1:

For the taxable year 2013, a corporation had Arizona taxable income of $35,000 consisting entirely of sales commissions on which it paid Arizona income tax of $2,439 (there were no tax credits for the year). In 2016, it was determined that the commissions were erroneously computed for 2013. Accordingly, the taxpayer pays back $10,000 of the commissions.

The taxpayer's taxable income for 2016, without regard to the $10,000 repayment, was $12,000. The tax on $12,000 is $660. Therefore, the taxpayer enters $660 on its 2016 Arizona income tax return on the line for computing the 2016 tax.

Under A.R.S. § 43-1130.01, this taxpayer computes the decrease in tax for 2013 as follows:

Tax Paid in 2013 on $35,000	$2,439
Tax Payable in 2013 on $25,000	1742
Decrease in prior year’s tax	$ 697

The $697 is treated as having been paid on the last day prescribed by law for the payment of the tax for 2016. Therefore, the excess of $37 ($697 - $660) may be refunded to the taxpayer.

Example 2:

For the taxable year 2010, a corporation had Arizona taxable income of $75,000 consisting of the following:

Capital gain	$90,000
Capital loss	<30,000>
Ordinary income	15,000
Taxable income	$75,000

On the taxable income of $75,000, the taxpayer paid Arizona income tax of $5,226 (there were no tax credits for the year).

In taxable year 2015, the taxpayer is required to restore the $90,000 capital gain. The taxpayer's taxable income for 2015, without regard to the $90,000 repayment, was $50,000.

Due to the restoration of the 2010 capital gain, this taxpayer has a $30,000 capital loss for the 2010 taxable year. Therefore, when this taxpayer computes the decrease in tax, it must compute a tax decrease for all taxable years to which it carries over or back a portion of the capital loss against any capital gains. (The example assumes no capital gain in the three years prior to 2010 to which the loss could be carried back, capital gains of $5,000 in years 2011 and 2014, and $40,000 of taxable income in each year.) Since the capital loss may be carried over to the extent of capital gain, the taxpayer may apply that amount of the loss carryover to each taxable year which reports capital gain (2011 and 2014). The remaining $20,000 of capital loss would be lost due to the five year limitation on loss carryforwards.

For each of the taxable years 2011, 2012, 2013, and 2014 the taxpayer had taxable income of $40,000.

The taxpayer's taxable income for 2015, without regard to the $90,000 repayment was $50,000. The tax on $50,000 is $3,000. Therefore, the taxpayer enters $3,000 on its 2015 Arizona corporate income tax return on the line for computing the 2015 tax.

Under A.R.S. § 43-1130.01, this taxpayer computes the decrease in tax for 2010, 2011, and 2014, as follows (2012 and 2013 remain unchanged since there was no capital gain):

Tax paid in 2010 on $75,000	$ 5,226	
Tax payable in 2010 on $15,000	$ 1,045	$ 4,181
Tax paid in 2011 on $40,000	$ 2,787	
Tax payable in 2011 on $35,000	$ 2,439	$ 348
Tax paid in 2014 on $40,000	$ 2,600	
Tax payable in 2014 on $35,000	$ 2,275	$ 325
Total Decrease in prior years' tax		$ 4,854

The $4,854 is treated as having been paid on the last day prescribed by law for the payment of the tax for 2015. Therefore, the excess of $1,854 ($4,854 - $3,000) may be refunded to the taxpayer.

How to report the decrease in tax from a prior year's return:

For amounts repaid in taxable years ***beginning after December 31, 2015***:

- Complete and include the department's Claim of Right Form for ***each*** prior tax year that included income that was repaid during the current tax year. This form is available on the department's website and can be downloaded from the corporate forms page. Use the Arizona Claim of Right-Corporate Form for the year in which the amount is repaid (and the credit is claimed), not the form for the year the income was reported. Be sure to use the correct Claim of Right Form for the tax return you are filing.

- A line is provided on the tax return to report the claim of right credit amount.
- For information on how to complete a Claim of Right Form and how to report the claim of right credit, see the specific instructions for the Claim of Right-Corporate Form.

For amounts repaid in taxable years ***beginning before December 31, 2015***:

- Complete and include *your own* schedule showing (1) each prior taxable year that included an amount repaid during the current tax year and (2) the computation for the decrease in tax for each prior tax year.
- On the tax return in which you are claiming the claim of right credit, write "A.R.S. 43-1130.01" on the line identified as *Total Payments* and enter the total amount of the decrease (claim of right credit) next to it.
- Include the claim of right credit amount in the total amount entered for *Total payments.*

APPLICABLE LAW:

A.R.S. § 43-1101(2) provides that the Arizona taxable income of a corporation is its federal taxable income adjusted by the modifications specified in A.R.S.§§ 43-1121 and 43-1122.

A.R.S. § 43-1121(23) requires an addition for the deduction referred to in Internal Revenue Code (I.R.C.) § 1341(a)(4) for restoration of a substantial amount held under a claim of right.

A.R.S. § 43-1121(24) requires an addition for the amount by which a capital loss carryover allowable pursuant to I.R.C. § 1341(b)(5) exceeds the capital loss carryover allowable pursuant to A.R.S. § 43-1130.01(F).

A.R.S. § 43-1122(23) provides a subtraction for the amount by which a capital loss carryover allowable pursuant to A.R.S. § 43-1130.01(F) exceeds the capital loss carryover allowable pursuant to I.R.C. § 1341(b)(5).

A.R.S. § 43-1130.01 provides for the computation of the Arizona income tax where a taxpayer restores a substantial amount held under a claim of right.

I.R.C. § 1341 provides for the computation of the federal income tax where a taxpayer restores a substantial amount held under a claim of right.

Grant Nülle, Deputy Director

Signed: September 13, 2016

Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to Department personnel. A tax procedure is a written statement issued by the Department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.