



Douglas A. Ducey
Governor

David Raber
Director

ARIZONA INDIVIDUAL INCOME TAX RULING ITR 15-1

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:

Will Arizona tax interest income derived from obligations of the State of Arizona, or any political subdivisions of Arizona, as evidenced by bonds, when an Arizona resident individual is required to include that income in his or her federal adjusted gross income?

RULING:

No, Arizona will not tax interest income received on obligations of the State of Arizona, or any political subdivisions of Arizona, as evidenced by bonds, when an Arizona resident individual is required to include that income in his or her federal adjusted gross income. The Arizona Constitution prohibits Arizona from taxing interest income derived from bonds of Arizona, its counties, municipalities or other subdivisions. Therefore, in situations where such income is included in a resident individual's federal adjusted gross income, the taxpayer shall subtract that income to the extent it is included in federal adjusted gross income.

DISCUSSION:

For federal income tax purposes, interest earned on bonds issued by states or political subdivisions of states is generally excluded from federal gross income and thus, federal income tax. However, interest on bonds issued by state and local governments can be included in federal adjusted gross income and be subject to federal income tax, when the proceeds of the bonds are not used for traditional government purposes. Additionally, a taxpayer will also include interest income from Build America Bonds (a form of taxable municipal bonds created under the American Recovery and Reinvestment Act of 2009) in federal adjusted gross income.

For Arizona income tax purposes, the starting point for an Arizona resident individual's income tax computation is the federal adjusted gross income. Therefore, the Arizona income tax return for a full-year Arizona resident will include all income reflected on the individual's federal return, including any federally taxable interest income received on

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obligations of the State of Arizona, or any political subdivisions of Arizona, as evidenced by bonds. This amount is then subject to specified additions and subtractions. The Arizona Constitution prohibits Arizona from taxing such interest income. Therefore an Arizona resident individual must subtract interest income from obligations of the State of Arizona, or any political subdivisions of Arizona, as evidenced by bonds, to the extent such income is included in his or her federal adjusted gross income.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) Const. Art 9 § 2(3) provides that public debts, as evidenced by the bonds of Arizona, its counties, municipalities or other subdivisions, shall be exempt from taxation.

A.R.S. § 43-1001(2) provides that the Arizona gross income of a resident individual is his or her federal adjusted gross income for the taxable year, computed pursuant to the internal revenue code.

Internal Revenue Code (I.R.C.) § 54AA provides that income from Build America Bonds (municipal bonds issued from April, 2009 through December, 2010 as part of the American Recovery and Reinvestment Act) is fully taxable to investors, but provides a federal tax credit.

I.R.C. § 103 generally provides that interest earned on bonds issued by states or political subdivisions of states generally is excluded from federal gross income.

Continental Bank v. Arizona Department of Revenue, (App. Div. 1 1981) 131 Ariz. 6, 638 P.2d 228 (1981) held that income arising from Arizona state, municipal and county bonds is exempt from taxation by A.R.S. § Const. Art 9 § 2(3), because principal is immune therefrom.

David Raber, Director

Signed: January 22, 2015

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

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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.