

ARIZONA CORPORATE TAX RULING

CTR 94-11

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:

The calculation of the allowable Arizona net operating loss for corporations that elect to file an Arizona consolidated corporate tax return.

APPLICABLE LAW:

State Tax Commission v. Oliver's Laundry & Dry Cleaning Co., 19 Ariz. App. 442, 508 P.2d 107 (1973) held that when a loss corporation and a gain corporation are merged, the loss may be carried over only to the extent that the losses being used to offset the subsequent gains are from the same business unit.

Arizona Revised Statutes (A.R.S.) § 43-1123 is the general statutory provision regarding Arizona net operating losses.

Arizona Administrative Code (A.A.C.) rule R15-2-1025.B.4 provides that net operating losses may not be carried forward if:

- a. they were incurred by a corporation prior to it doing business in Arizona; or
- b. they were incurred by a corporation prior to a merger, consolidation or other type of reorganization with another corporation or group of corporations, to the extent that post-merger, consolidation or reorganization gains are not attributable to the same business unit and enterprise as that which incurred the prior losses.
(Emphasis added)

A.R.S. § 43-1121.7 provides that, in computing Arizona taxable income of a corporation, the amount of net operating loss taken pursuant to section 172 of the Internal Revenue Code shall be added to Arizona gross income.

DISCUSSION:

This ruling addresses:

- a) the calculation of Arizona net operating losses for corporations that had originally filed separate income tax returns or combined income tax returns and which subsequently elect to file a consolidated return to Arizona; and
- b) the calculation of Arizona net operating losses for corporations that were members of an affiliated group that filed consolidated income tax returns to Arizona when one or more corporations cease to be members of the affiliated group.

The principles followed in State Tax Commission v. Oliver's Laundry & Dry Cleaning Co., supra, and A.A.C. R15-2-1025.B.4 are the keys to these calculations. These principles require that only a loss from the same business unit that is reporting the income may be carried forward to reduce that income.

That portion of the consolidated income (loss) which is considered related to a specific business unit (separate corporation or combined group) within the consolidated group is determined by computing a ratio based on the property, payroll, and sales factors (dollar amounts) of the separate company or combined group to the consolidated group's total property, payroll, and sales factors (dollar amounts). This ratio is multiplied by the consolidated net income subject to apportionment. This product is the portion of the consolidated net income or loss related to that business unit (separate company or combined group). The Arizona portion of that business unit's net income or loss is computed by multiplying the income related to that business unit by that unit's ratio of Arizona property, payroll, and sales factors (dollar amounts) to that unit's total property, payroll, and sales factors (dollar amounts) plus any income or loss allocable to Arizona.

The portion of the Arizona income or loss related to a corporation or combined group included within a consolidated return is determined by the following formula:

$$(A/B \times C \times D/A) + E = L$$

A/B = Ratio based on separate company's or combined group's property, payroll, and sales factors to consolidated group's total property, payroll, and sales factors

C = Consolidated income subject to apportionment

D/A = Ratio based on separate company's or combined group's Arizona property, payroll, and sales factors to separate company's or combined group's total property, payroll, and sales

factors

E = Separate corporation or combined group income and expense allocable to Arizona

L = (a) The amount of separate company or combined group income within the consolidated return to which the separate company or combined group loss can be applied; or

(b) the amount of the consolidated loss available for carryover against consolidated income after some corporations cease to be members of the affiliated group

This computation should be made for each year of consolidated filing to determine:

(a) what portion of the consolidated income may be offset by prior separate company or combined group losses; or

(b) what portion of the consolidated loss may be carried forward against consolidated income after some corporations cease to be members of the affiliated group.

An affiliated group of corporations that elects or is required to file an Arizona consolidated return may include corporations that previously filed separate returns to Arizona, or that were components of a unitary business filing a combined return to Arizona. The consolidated return may also include only some members of the combined group, as some corporations may not be included in the consolidated return due to stock ownership requirements. The former combined group may also be identical to the consolidated group.

The following examples illustrate the application of the formula.

Example 1:

An affiliated group of 30 corporations elects to file a consolidated return to Arizona. The affiliated group includes a unitary group of 25 corporations that previously filed a combined return to Arizona, 2 nonunitary corporations that previously filed separate returns to Arizona, and 3 corporations which did not file to Arizona.

The combined group and the 2 separate corporations must each apply the formula stated in this ruling to determine the amount of separate company or combined group income within the consolidated return to which the separate company or combined group loss can be applied. Losses of the corporations which did not file to Arizona cannot be carried over.

Example 2:

An affiliated group of 20 corporations elects to file an Arizona consolidated return. The affiliated group includes 8 corporations that were part of a unitary business required to file a combined return to Arizona. The unitary business group consisted of 10 corporations. The 2 remaining corporations cannot be included in the affiliated group due to stock ownership requirements.

A portion of the Arizona NOLs of the combined group must be allocated to the 8 corporations that are members of the consolidated group. The 8 corporations (as a group) must apply the formula stated in Arizona Corporate Tax Ruling CTR 91-2 to determine the amount of the combined group's loss that is available for carryover by the 8 corporations.

The 8 corporations (as a group) will then apply the formula stated in this ruling to determine the amount of the 8 corporations' income (as a group) within the consolidated return to which the net operating loss allocated to the 8 corporations may be applied.

Example 3:

An affiliated group of 100 corporations elects to file an Arizona consolidated return for the taxable year ending December 31, 1994. In a subsequent taxable year, 25 corporations cease to be members of the affiliated group. The remaining members of the affiliated group must apply the formula stated in this ruling to determine the amount of the consolidated loss available for carryover by the remaining members of the affiliated group.

CONCLUSION AND RULING:

When a separate company or combined group which has incurred a net operating loss joins in the filing of a consolidated return, the loss may be carried forward only to the extent of that portion of the consolidated income related to the business unit which incurred the prior loss.

When a group of corporations files a consolidated return reporting a loss and one or more corporations cease to be members of the affiliated group, only that portion of the consolidated loss related to the remaining members of the affiliated group may be carried forward against subsequent income of the consolidated group.

This ruling is not intended to limit the application of a consolidated net operating loss incurred by and carried forward against the consolidated income of an affiliated group consisting of the

same members.

Harold Scott, Director

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.