

# ARIZONA DEPARTMENT OF REVENUE

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## ARIZONA CORPORATE TAX RULING CTR 02-3

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### **ISSUE:**

Is income from a qualified electing fund (QEF) taxable?

### **APPLICABLE LAW:**

Arizona Revised Statutes (A.R.S.) § 43-1122(7) states that the amount of dividend income from foreign corporations is subtracted from Arizona gross income.

Internal Revenue Code (IRC) § 316 states that a dividend means any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

IRC § 1295 provides that a taxpayer that is a direct or indirect shareholder of a passive foreign investment company (PFIC) may elect under IRC § 1295 to treat the foreign corporation as a QEF.

IRC § 1293 provides the method of taxation for a QEF.

IRC § 1291 provides that when a taxpayer becomes a QEF it may elect to treat certain gross income as a dividend.

IRC § 1296 provides that a U.S. shareholder in a PFIC can elect to mark-to-market the stock of the PFIC.

### **DISCUSSION:**

Arizona allows a subtraction from Arizona gross income for dividends received from a foreign corporation pursuant to A.R.S. § 43-1122(7). In addition, Arizona provides for a subtraction from Arizona gross income for controlled corporation dividends in A.R.S. § 43-1122(5). In this statute, dividends are defined by IRC § 316.

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The QEF income that is included in "other dividends" on the federal income tax returns should be treated as a foreign dividend and, thus, be non-taxable for Arizona income tax purposes. This income is coming from earnings and profits of the PFIC, which is the main definition for classifying income as a dividend.

The QEF income from the IRC § 1291 election that is treated as a dividend should be considered a foreign dividend and non-taxable for Arizona purposes<sup>1</sup>. According to federal Form 8621, Part IV, line 10d, this income is reported on the federal income tax return as dividend income since the distributions come from earnings and profits. This is consistent with the department's treatment of sub-part F income, which is a deemed dividend.

A U.S. shareholder in a PFIC can also elect on federal Form 8621 to mark-to-market the stock of the PFIC. This election would require the U.S. shareholder of the PFIC to treat the excess of the fair market value of such stock as of the close of such taxable year over its adjusted basis as ordinary income. This excess ordinary income (loss) is included in "other income" on the federal corporate income tax return (Form 1120). The income from the mark-to-market election does not come from earnings and profits of the PFIC. Rather it is a market-to-basis adjustment. This "other income" would, therefore, not be classified as a dividend.

### **RULING:**

The QEF income from the IRC § 1291 election, that is treated as a dividend, is considered a foreign dividend and may be subtracted from Arizona gross income pursuant to A.R.S. § 43-1122(7).

However the income from the mark-to-market election does not come from earnings and profits of the PFIC but is a market-to-basis adjustment. This "other income" would, therefore, not be classified as a dividend and would be taxable income.

Mark W. Killian, Director

Signed: August 12, 2002

### 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

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<sup>1</sup> A.R.S. § 43-961.5 provides that expenses related to non-taxable income are not allowed as a deduction in computing taxable income.

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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.