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ARIZONA FIDUCIARY INCOME TAX RULING FTR 07-1

(Effective for taxable years beginning from and after December 31, 2007)

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ISSUE:

How is the income from the portion of an Electing Small Business Trust (ESBT) that consists of stock in one or more S corporations taxed for Arizona purposes?

APPLICABLE LAW:

Internal Revenue Code (I.R.C.) § 641(b) provides that the taxable income of a trust is computed in the same manner as in the case of an individual, except as otherwise provided in this part (I.R.C. subtitle A, chapter 1, subchapter J, part 1).

I.R.C. § 641(c)(1) provides that “the portion of any ESBT which consists of stock in 1 or more S corporations shall be treated as a separate trust” and the amount of the tax imposed on the separate trust shall be determined with the modifications in I.R.C. § 641(c)(2). The trust that holds the S corporation stock is taxed at the highest rate under I.R.C. § 1(e).

Treasury Regulation (Treas. Reg.) § 1.641(c)-1(a) provides that an ESBT is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. However, the ESBT is treated as a single trust for administrative purposes such as having one taxpayer identification number and filing one return.

Treas. Reg. § 1.641(c)-1(b)(2) defines “S portion” as the portion of the ESBT that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

Treas. Reg. § 1.641(c)-1(b)(3) defines “non-S portion” as the portion of the ESBT that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

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Treas. Reg. § 1.641(c)-1(d) states the “taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.”

Arizona Revised Statutes (A.R.S.) § 43-102(A)(2) provides that it was the intent of the Legislature to “adopt the provisions of the federal Internal Revenue Code relating to the measurement of taxable income for ..., trusts, ..., to the end that taxable income reported each taxable year by a ..., trust, ... to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in this title.”

A.R.S. § 43-102(A)(3) provides that it was the intent of the Legislature to achieve the results in paragraph 2 “by the application of the various provisions of the federal Internal Revenue Code relating to the definitions of income, ..., resulting in an amount called ... taxable income for ..., trusts, ... in the Internal Revenue Code.”

A.R.S. § 43-1301 defines “Arizona gross income” for a resident trust as the “taxable income for the tax year, computed according to the Internal Revenue Code.” “Arizona gross income” for a nonresident trust is defined as “taxable income from sources within this state for the taxable year, computed according to the Internal Revenue Code.”

DISCUSSION:

According to the instructions for federal Form 1041, only the taxable income of the non-S portion of the ESBT is included on the front of the federal return. The taxable income of the S portion must be figured on a separate schedule and included with the return. The tax on the S portion is added to the tax on the non-S portion of the ESBT in Schedule G of the federal return.

The exclusion of the S portion of the ESBT from the taxable income line on the front of the federal return does not mean that the S portion of the ESBT has no taxable income. It is clear from I.R.C. § 641 and the related regulation that the ESBT is treated as two separate trusts for purposes of tax computation with separate taxable incomes computed for the S portion and the non-S portion of the trust. While the Internal Revenue Service (IRS) chose, in its regulations and forms, to have the taxable income of the S portion of the ESBT computed on a separate schedule, rather than on Form 1041 itself, with only the tax of the S portion being added to the form, this does not change the fact that the S portion has taxable income.

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A.R.S. §§ 43-102 and 43-1301 provide that Arizona uses federal taxable income computed pursuant to the Internal Revenue Code as its starting point for calculation of Arizona taxable income. How the IRS chooses to arrange items or label them on the federal tax form does not determine the taxability of those items for Arizona purposes, if they fall within the definition of taxable income for federal and Arizona tax purposes.

RULING:

Arizona's computation of Arizona taxable income starts with federal taxable income computed pursuant to the Internal Revenue Code and is not limited to only federal taxable income shown on a federal form, such as Form 1041. The taxable income of the S portion is not shown on the Form 1041, but the schedule computing the taxable income of the S portion is part of the federal return filed. Because the ESBT is in fact a single entity and Arizona does not have a provision to impose a different rate of tax on the S portion, the ESBT must file a single Arizona income tax return for fiduciaries, Arizona Fiduciary Income Tax Return (Form 141AZ). The ESBT must include the federal taxable income from both the S portion holding its S corporation stock and the non-S portion holding its other assets on its Form 141AZ.

Gale Garriott, Director

Signed: December 7, 2007

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 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.