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ARIZONA INDIVIDUAL INCOME TAX RULING ITR 16-2

(Supersedes ITR 13-2)

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:

Composite Individual Income Tax Returns

Is a composite individual income tax return consisting of nonresident individual shareholders of an S corporation and nonresident individual partners of a partnership acceptable for Arizona income tax purposes in lieu of each such shareholder or partner filing a separate Arizona individual nonresident income tax return?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 42-1004(A)(1) authorizes the department to formulate policies, plans and programs to effectuate the missions and purposes of the department.

A.R.S. § 43-301 sets forth the individual filing requirements.

A.R.S. § 43-1091 defines "gross income" of a nonresident.

A.R.S. § 43-1092(B) provides that any income received by nonresidents which is derived from a small business corporation making an election pursuant to A.R.S. § 43-1126 is considered taxable income of this state.

A.R.S. § 43-1094 defines "adjusted gross income" of a nonresident.

A.R.S. § 43-1095 defines "taxable income" of a nonresident.

Arizona Administrative Code (A.A.C.) rule R15-2C-601(A)(2) provides that the gross income of a nonresident who is a member of a partnership includes the member's distributive share of the net income of the partnership to the extent that the member's distributive share is derived from sources within Arizona.

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 16-2

(Supersedes ITR 13-2)

Page 2

DISCUSSION:

Arizona laws do not directly address the issue of composite individual income tax returns. However, authority for the department to allow and to accept the subject composite return is implied in the general powers and duties of the department.

The laws cited under Applicable Law (above) provide statutory basis for requiring certain information to be included in a composite return.

RULING:

The Arizona Department of Revenue will accept a composite return of the qualifying nonresident shareholders of an S corporation or of the qualifying nonresident individual partners of a partnership¹ if the conditions specified below are met:

1. Members included in the composite return must be nonresident individuals of the state for the full taxable year. A distribution to a disregarded LLC or a Grantor Trust by an S corporation or a partnership is treated as a distribution to the owner of the disregarded LLC or the Grantor Trust². If the owner of the disregarded LLC or the Grantor Trust meets all of the other requirements to be a member of the composite return, the owner may be included.
2. Members included in the composite return must have no income (including spouse's) from sources within the state other than his or her distributive share of S corporation or partnership income allocable to Arizona. Partners of two or more affiliated partnerships that report the income from those partnerships to Arizona on one composite return will not be considered to have Arizona income from more than one source.
3. Deceased members may not be included in the composite return.
4. All members included in the composite return must have the same tax year for income tax purposes.

¹ A.R.S. § 29-857 provides that, for Arizona income tax purposes, a domestic or foreign limited liability company (LLC) and its members shall be taxed as if the LLC is a partnership or a corporation, or is disregarded as an entity separate from its owner, as determined pursuant to the Internal Revenue Code defined in A.R.S. § 43-105. Therefore, in this ruling, any reference to a partnership also includes an LLC that is taxed as a partnership for federal income tax purposes. Likewise, any reference to an S corporation also includes an LLC that is taxed as an S corporation for federal income tax purposes.

² A grantor type trust is a legal trust that is not recognized as a separate entity for income tax purposes. The grantor is treated as the owner of the trust property and, as such, the trust income is reported on the grantor's individual income tax return.

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 16-2

(Supersedes ITR 13-2)

Page 3

An affidavit stating that the member qualifies for inclusion in a composite return under (1) through (4) above must be executed by each member included in the composite return. The affidavits must be maintained in the S corporation or partnership files subject to review by the Department of Revenue.

A Power of Attorney authorizing the S corporation or partnership to file a nonresident income tax return on behalf of the nonresident member must be executed by each qualifying member for each year the member wishes to be included in the composite return. The Powers of Attorney must be maintained in the S corporation or partnership files subject to review by the Department of Revenue.

The following limitations and conditions shall apply to those members included in the composite return:

1. Only the standard deduction in lieu of itemized deductions will be allowed.
2. No tax credits will be allowed.
3. No net operating losses will be allowed.
4. A composite return filed by an entity may be on behalf of some or all of its members which are eligible to participate. However, a composite return cannot be filed with fewer than ten participating members.
5. Any refund of overpayment of income taxes made on a composite basis must be remitted to the entity for distribution to the members.
6. No person who is required to make payments of Arizona estimated tax may be a member of the composite return. An individual who participates in the filing of a composite return cannot make voluntary Arizona estimated income tax payments. The entity filing the composite return may make voluntary estimated payments on a composite basis on behalf of the participating members. Such estimated income tax payments must be remitted with Arizona Form 140ES, under the filing entity's employer identification number.
7. A composite return may not be changed or corrected except by an amended composite return filed by the entity.

The filing of the form itself shall consist of the following:

1. The form for filing a composite return will be the *Arizona Nonresident Personal Income Tax Return*, Form 140NR.

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 16-2

(Supersedes ITR 13-2)

Page 4

2. The Residency Status box, *Composite Return*, on page 1 must be checked.

Note: To amend the composite return use the *Arizona Individual Amended Income Tax Return*, Form 140X. For an amended return, filed for a taxable year ending on or before 12/31/2014, the return must be labeled, "*Composite Return*" on top of page 1 of the form. For an amended return, filed for a taxable year beginning after 12/31/2014, the Residency Status box, *Composite*, on page 1 must be checked.

3. The taxpayer's name and address shown on the front of Form 140NR will be the entity's name and address.
4. The taxpayer's identifying number shown on the front of Form 140NR will be the entity's employer identification number.

In the case of two or more affiliated partnerships reporting income from the members on one composite return, the taxpayer's name, address, and employer identification number shown on the front of Form 140NR will be the primary partnership's name address and identifying number. The name, address, and identifying number of the remaining affiliated partnerships must be reported on an attached schedule.

5. A comprehensive schedule must be attached showing the names, addresses, social security numbers, and mathematical calculations for the Arizona income ratio (percentage), the standard deduction, and the Arizona tax liability for each nonresident partner or shareholder included in the composite return. In the case of two or more affiliated partnerships reporting income from the members on one composite return, a schedule must be attached showing the separately computed income from each partnership for each partner and the computation of the member's tax liability which shall be computed on the total of the member's income from those partnerships less allowable subtractions and exemptions.
6. The names, addresses, and social security numbers of any excluded members must be disclosed on the schedule.
7. The composite return must be signed by the partners or corporate officers authorized to sign the partnership return or S corporation income tax return.

Each member's deductions, exemptions, and liability shall be computed separately in the following manner:

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 16-2

(Supersedes ITR 13-2)

Page 5

1. The Arizona income ratio of each member's total income in relation to the federal income must first be computed. This is done by dividing the amount shown on the member's Arizona nonresident Schedule K-1 by the federal adjusted gross income shown on the member's individual federal income tax return. Each member's income ratio must be rounded to three decimal places and cannot be greater than 1.000.
2. The standard deduction for each member shall not exceed the maximum amount allowable for that member for the specific tax year being filed. The number of dependents, age sixty-five or over, blind and personal exemptions being claimed are to be multiplied by the amount allowable for the year being filed. Both the standard deduction and exemption amounts are then to be multiplied by the Arizona income ratio computed above.
3. The taxable income for each participating member shall be computed by beginning with the Arizona income shown on the member's nonresident Schedule K-1. From this amount, the amounts computed in items 1 and 2 above shall be deducted. The taxable income for each participating member reporting income from two or more affiliated partnerships shall be computed by beginning with the total of the Arizona income shown on the member's nonresident Schedule K-1s from each partnership.
4. Each member's tax liability shall be computed separately based on the separate taxable income using the appropriate tax table for the tax year involved.
5. The aggregate amounts for income, exemptions, deductions, and liabilities for all of the participating members are to be reported on the return.

However, members who are participating in the filing of a composite return may elect to waive their right to claim all allowable exemptions, subtractions, and deductions. If this is done, the tax is to be calculated directly upon the member's pro rata share of the entity income at the appropriate individual tax rate for the year. A participating member making this election must sign a waiver relinquishing the right to claim all of the exemptions, subtractions, and deductions allowed on the composite return. The waivers must be maintained in the S corporation or partnership files subject to review by the Department of Revenue.

The state income tax liabilities of the participants included in the composite return may not be borne by the S corporation or partnership, but must be paid by the member by direct remittance to the state, remittance to the S corporation or partnership or by a charge against a shareholder's or partner's loan account.

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 16-2

(Supersedes ITR 13-2)

Page 6

Composite returns are due on the 15th day of the fourth month following the close of the taxable year of the shareholders or partners included in the composite return. Extension of time to file will be granted on a composite basis only and must be requested from the state (exclusive of whether or not a federal extension has been obtained). Arizona Form 204 must be used when requesting an extension. The extension request must be filed under the entity's employer identification number and payment of 90 percent of the composite tax liability must accompany the extension request.

A composite return cannot be filed electronically. All composite returns, both original and amended, must be mailed to the address on the form.

Individual members are liable for any proposed assessment resulting from an audit, even though a composite return has been filed.

The filing of a composite return on behalf of the nonresident shareholders or partners *does not relieve* the S corporation or partnership from the requirement to file its own state entity return for the tax year, pursuant to Title 43. An S corporation must file an Arizona Form 120S; a partnership must file an Arizona Form 165.

A Grantor Trust whose nonresident owner/grantor is included in a composite return is not relieved from the requirement to file its own state entity return for the tax year. The Grantor Trust must file Arizona Form 141AZ.

Grant Nülle, Deputy Director

Signed: September 13, 2016

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.

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