

ARIZONA DEPARTMENT OF REVENUE

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 94-4

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:

May an individual who is a shareholder of an S corporation subtract from Arizona gross income his or her share of S corporation income which has also been subject to Arizona taxation at the corporate level?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-1001 provides that the Arizona adjusted gross income of a resident individual is the federal adjusted gross income subject to the modifications specified in A.R.S. §§ 43-1021 and 43-1022.

A.R.S. § 43-1022 prescribes items which are allowable subtractions in the computation of an individual's Arizona adjusted gross income.

A.R.S. § 43-1126 provides that an S corporation is subject to Arizona income tax only to the extent it is subject to federal income tax.

Internal Revenue Code (I.R.C.) § 1366 provides that the gross income of a shareholder of an S corporation must include, on a pro rata basis, each item of income, loss, deduction, or credit of the S corporation. This section provides special rules for S corporation income which is also taxed at the corporate level.

Arizona State Tax Commission v. Kieckhefer, 67 Ariz. 102, 191 P.2d 729 (1948) held that a right to a deduction does not exist in the absence of statutory authorization and a deduction will not be allowed for items not within the terms of the statute.

DISCUSSION:

For Arizona purposes, the income of an S corporation is taken into account by its shareholders in the same manner and to the same extent as it is for federal income tax purposes. Although S corporation income is generally passed through to the shareholders in a manner similar to partnership income passing through to partners, in some cases certain types of income (such as excess net passive income, capital gains, or certain built-in gains) are taxed at the corporate level. That income taxed at the

ARIZONA INDIVIDUAL INCOME TAX RULING

ITR 94-4

Page 2

corporate level is passed through to the shareholder (with a reduction for federal income tax paid by the corporation) and is also includable on the shareholder's individual return.

To the extent S corporation income is includable in a resident individual shareholder's federal adjusted gross income, such income will be included in that individual's Arizona gross income. The individual shareholder's Arizona gross income is then subject to specified additions and subtractions in computing Arizona taxable income. Items which are allowable subtractions are only those items specifically prescribed by statute.

Arizona taxes S corporations and S corporation shareholders in the same manner as they are taxed for federal purposes. In some cases, both the S corporation and the shareholder may be subject to Arizona income tax on the same S corporation income since the S corporation may have already been subject to Arizona income taxes on income included in the individual's Arizona gross income. Arizona statutes do not provide a subtraction for an individual shareholder's share of S corporation income which is also subject to Arizona taxation at the corporate level. Therefore, to the extent S corporation income (including that which was taxed at the corporate level) is includable in an individual shareholder's Arizona gross income, such income is subject to Arizona income tax.

RULING:

S corporation income which is taxed at the corporate level is passed through to the shareholder (with a reduction for federal income tax paid by the corporation) and is includable on the shareholder's individual income tax return. An individual who is a shareholder of an S corporation cannot subtract from Arizona gross income his or her share of S corporation income which is also subject to Arizona taxation at the corporate level.

Harold Scott, Director

Signed: March 30, 1994

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.