

9/19

1. A.R.S. §§ 43-1021(4) and 43-1022(8)

A.R.S. §§ 43-1021(4) and 43-1022(8) different treatment in pensions for pensions where the first payment was received prior to December 31, 1978. We will recommend these be repealed due to their obsolescence.

The addition in A.R.S. § 43-1021(4) and the subtraction in A.R.S. § 43-1022(8) are transitional provisions of the 1978 Arizona Income Tax Act. These sections generally require that a taxpayer adjust Arizona gross income by adding amounts in excess of or subtracting amounts less than the taxpayer's cost of an annuity when the first payment from such annuity was received prior to December 31, 1978. Prior to the 1978 Act, the Arizona treatment of annuity income was different than the federal treatment. For Arizona purposes, the taxpayer excluded from Arizona gross income all annuity payments received until the taxpayer recovered the cost of the annuity. After the cost of the annuity was recovered, the total annuity payments received were included in Arizona gross income (former A.R.S. § 43-112(b)(3)). However, for federal purposes, only a portion of the cost was excluded from each payment, which in effect, spread the tax-free portion of the annuity over the annuitant's life expectancy. It was recently determined that if there are any taxpayers still affected by this provision, that those taxpayers would be required to make an addition to income and not be able to take a subtraction, since the costs of such pensions would have been recovered for Arizona purposes a long time ago. I would also note that assuming a person started drawing the pension at age 50, that person would be at least 85 years old at some point during 2013. Since age 50 would have been young to draw a pension, it could probably be safely assumed that very few, if anyone would be still alive with income sufficient to require the addition.

2. A.R.S. §§ 43-1021(7) and 43-1022(11)

A.R.S. §§ 43-1021(7) and 43-1022(11) different basis of property held for the production of income and which is sold or otherwise disposed of during the taxable year, except depreciable property used in a trade or business. We will recommend these be repealed due to their obsolescence.

The addition in A.R.S. §§ 43-1021(7) and the subtraction in A.R.S. § 43-1022(11) are transitional provisions of the 1978 Arizona Income Tax Act. These sections generally require a taxpayer to adjust Arizona gross income by either adding or subtracting the difference in the adjusted basis of property held for the production of income and which is sold or otherwise disposed of during the taxable year, except depreciable property used in a trade or business. These sections appear to apply to only inventories, and

mining (mining is depleted rather than depreciated) since any difference in depreciable property and capital losses had their own transitional provisions (former A.R.S. § 43-1026 capital losses and former A.R.S. § 43-1027 depreciable property).

With respect to inventory methods, under the Income Tax Act of 1954, a taxpayer could have used a different inventory method for Arizona purposes than the taxpayer used for federal purposes. Starting with the Arizona Income Tax Act of 1978, the taxpayer would have been required to use the same inventory method for Arizona purposes as used for federal purposes. This could have resulted in a different basis in the property at the time the property was sold or otherwise disposed. However, since any inventory on the books at the time the Arizona Income Tax Act of 1978 was enacted is by now long gone, it does not appear that this transitional provision is necessary any longer.

With respect to mining expenses (different basis resulting is the difference between depletion taken at the Arizona level and the federal level due to deferred exploration expenses deducted as depletion), the addition and subtraction are probably no longer applicable to individuals or partnerships, since mining operations by these types of entities would probably be on a smaller scale and either depleted or disposed of by now. However, these sections are still referenced in the corporate provisions under A.R.S. § 43-1127. Again, because the provisions apply to only differences in basis from property acquired prior to 1978, they may not even have a corporate application. However, if these sections are repealed, consideration should be given to enacting a specific provision for corporation income tax purposes to account for the difference in basis due to different depletion methods required for federal purposes than for Arizona purposes for deferred exploration expenses.

3. A.R.S. §§ 43-1021(25), 43-1022(27), and 43-1022(28)

A.R.S. §§ 43-1021(25), 43-1022(27), and 43-1022(28) all are related to Arizona not conforming to the federal bonus depreciation provisions.

A.R.S. § 43-1021(25) Requires an addition for all depreciation taken on the federal return.

A.R.S. § 43-1022(27) This subtraction originally required a subtraction of depreciation based on the amount the federal depreciation would have been if the taxpayer had opted out of the federal bonus depreciation. Now the subtraction is based on the amount that would have been allowed if the federal bonus depreciation had been 10% of the bonus depreciation amount allowed federally. If the federal bonus depreciation is 50%, Arizona will allow a bonus depreciation of 5% (10% of 50%).

A.R.S. § 43-1022(28) This provision allows a subtraction when the property is sold, based on the difference in basis caused by the adjustments to depreciation.

4. **A.R.S. § § 43-1021(26), and 43-1022(29)**

A.R.S. § § 43-1021(26), and 43-1022(29) are related to Arizona not conforming to the federal section 179 expensing provisions.

A.R.S. § 43-1021(26) Previously, this required the addition of all federal section 179 expense deducted in excess of \$25,000 (the current amount allowed federally is \$500,000). In the last legislative session this addition was changed to only apply to assets acquired prior to 2013.

A.R.S. § 43-1022(29) Allows a deduction of 1/5 of the amount added back under the addition in A.R.S. § 43-1021(26) each year for 5 years. Even though the addition, is no longer required the subtraction will still apply through 2016.

5. **A.R.S. § 43-1021(31)**

A.R.S. § 43-1021(30) required the addition of the amount of unemployment compensation that was excluded from federal adjusted gross income pursuant to section 85(c) of the internal revenue code as added by section 1007 of the American recovery and reinvestment act of 2009 (P.L. 111-5).

For the 2009 taxable year, Arizona did not fully conform to federal tax law changes. For federal purposes, a taxpayer that received unemployment income in 2009 was allowed to exclude up to \$2,400 of that income on the 2009 federal return. Arizona did not conform to the provision and required the taxpayer to make an addition to Arizona income for the excluded amount. Since this provision was applicable to only 2009, this provision is now obsolete and should be repealed.

6. **A.R.S. § § 43-1021(31), 43-1021(32), 43-1022(31)and 43-1022(32)**

A.R.S. § § 43-1021(31), 43-1021(32), 43-1022(31), and 43-1022(32) are all related to Arizona not conforming to a federal provision for tax years 2009 and 2010 that allowed the deferral of discharge of indebtedness income (DOI) from the business reacquisition of a debt instrument under IRC section 108(i).

For the 2009 taxable year, Arizona did not fully conform to federal tax law changes. For federal purposes for 2009, a taxpayer may have made a special election for the taxable year

to include DOI income in connection with the reacquisition of a business debt instrument, ratably over a 5 year period. A taxpayer that made this election will generally include this income in federal adjusted gross income over a 5-year period beginning with the 2014 taxable year. In addition, when the IRS deferred the recognition of income it also deferred the recognition of subtractions for any original issue discount (OID) until the income is recognized.

Arizona did not adopt the special federal DOI income deferral provisions or the related deferral of the OID. For Arizona purposes, if the taxpayer made the federal election to defer the inclusion of DOI income under I.R.C. § 108(i), the taxpayer must have made an addition to income to include that income for Arizona purposes under A.R.S. § 43-1021(31) in 2009 or 2010. In addition, the taxpayer is allowed a subtraction under A.R.S. § 43-1022(31) each year for the OID that was deferred federally.

When the IRS includes the DOI income starting in 2014 (generally) taxpayer's will be allowed a subtraction (A.R.S. § 43-1022(32)) in their Arizona return for the DOI included in their federal return to the extent it was added back for Arizona purposes in a prior year. In addition, when the IRS allows OID that was originally deferred Arizona will add back the amount so that it will not be allowed twice for Arizona (A.R.S. § 43-1021(32)).

7. A.R.S. § 43-1022(4)

A.R.S. § 43-1022(4) provides a subtraction for certain amounts distributed from an IRA (provided in I.R.C. § 408) or a retirement plan of a self-employed individual (provided in I.R.C. § 401) to the extent that the total amount subtracted in all tax years do not exceed the total of all contributions made by the taxpayer to the plan before December 31, 1975.

A.R.S. § 43-1022(4) is a transitional provision of the 1978 Arizona Income Tax Act. This section provides a subtraction for certain amounts distributed from an IRA (provided in I.R.C. § 408) or a retirement plan of a self-employed individual (provided in I.R.C. § 401) to the extent that the total amount subtracted in all tax years do not exceed the total of all contributions made by the taxpayer to the plan before December 31, 1975. It appears that prior to December 31, 1975, Arizona did not allow an individual to deduct from Arizona gross income contributions made to those types of retirement plans. For federal purposes, such contributions were deductible (my research indicates IRAs starting in 1975 and Keoghs in 1963). When the IRA or the pension is distributed, the distributions comprised of amounts contributed prior to December 31, 1975 may be included in the taxpayer's federal adjusted gross income.

However, the amounts contributed prior to December 31, 1975 while the taxpayer was an Arizona resident would have already been taxed by Arizona.

My research indicates that the generally, a person can start taking distributions from these plans as early as age 59½ and as late as age 70½. The period to which the subtraction applies are actions taken prior to 1976 (38 years ago). My research also indicates that for the purpose of an IRA, there would only be 1 year involved (1975) and the total maximum subtraction could be no more than \$1,500. It is somewhat different with the self-employed retirement plan. However, one article I read indicated that the number of private defined benefit plans starting declining in 1984 (In 1983 there were 175,143 plans, but in 2008 there were only 46,926 plans). This number is probably even much smaller today after the last great recession. With that in mind, it is probably safe to assume that there are few, if any, plans in existence today for self-employed individuals that were created between 1963 and 1975 by Arizona residents that have not yet retired

8. A.R.S. § 43-1022(7)

A.R.S. § 43-1022(7) is a subtraction for the amount of any income tax refund received from other states.

A.R.S. § 43-1022(7) provides a subtraction from Arizona gross income for the amount of any income tax refunds that were received from states other than Arizona and that were included as income in computing federal adjusted gross income. This subtraction was enacted under the 1978 Arizona Income Tax Act as former A.R.S. § 43-1022(13). This provision was deemed necessary since under former A.R.S. § 43-1043(A) (1978 Act) and former A.R.S. § 43-123.05(1) (1954 Act) a taxpayer could take an itemized deduction for the amount of taxes paid during the taxable year, except a taxpayer was precluded from taking a deduction for income taxes imposed by another state or foreign country. Under the Arizona Income Tax Act of 1954, if the deduction exceeded the taxes actually paid and the taxpayer got a refund in the subsequent year, the taxpayer was required to include that refund in gross income to the extent the deduction exceeded the taxes (former A.R.S. § 43-112(b)(17)). However, with the enactment of the Arizona Income Tax Act of 1978, the starting point for the Arizona computation was the federal adjusted gross income and the "tax benefit rule" under former A.R.S. § 43-112(b)(17) was no longer applicable. Therefore, A.R.S. § 43-1022(7) was enacted to preclude Arizona from taxing refunds from other states since the taxpayer was never allowed to deduct the taxes giving rise to that refund. This all changed with Laws 1990, 3rd SS, Ch 3. Under Laws 1990, 3rd SS, Ch 3, the Arizona itemized deductions were repealed including former A.R.S. § 43-1043, and new A.R.S. § 43-1042 was enacted to provide that the itemized deductions allowed for Arizona purposes were basically the same deductions allowed for federal purposes. With the 1990 enactment, a taxpayer

was (and is currently) allowed to take a deduction for taxes paid to another state. However, when former A.R.S. § 43-1043 was repealed, the Legislature appear to have overlooked the repeal of former A.R.S. § 43-1022(13) (the subtraction for other state tax refunds).

9. A.R.S. § 43-1022(17)

A.R.S. § 43-1022(17) provides a subtraction for exploration expenses that were deferred by an individual prior to 1990.

A.R.S. § 43-1022(17) provides for a subtraction for the amount of exploration expenses that is determined pursuant to I.R.C. § 617, that has been deferred in a taxable year ending before January 1, 1990 and for which a subtraction has not previously been made. The subtraction shall be made on a ratable basis as the units of produced ores or minerals discovered or explored as a result of this exploration are sold.

10. A.R.S. § 43-1022(33)

A.R.S. § 43-1022(33) provides a subtraction for certain net operating losses from 2008 or 2009 that were carried back for federal income tax purposes but carried forward for Arizona purposes.

Generally, for individual income tax Arizona conforms to the federal net operating loss treatment and the net operating loss claimed on the federal return will flow through to the Arizona return. In most cases this would allow the loss to be carried back for two (sometimes three) years and forward 20 years.

In 2009, the federal government passed a provision allowing for a 5-year carryback of net operating losses for losses created in 2008 or 2009. Arizona did not conform to this additional carryback. Therefore, taxpayers that amended their federal returns to carryback 2008 and 2009 losses 5 years were only allowed to carryback for the two or three years they were allowed before the change. The difference between the amount used during the federal carryback period and the Arizona carryback period is allowed to be carried forward and taken as a subtraction on the Arizona return based on when it would have been used if the taxpayer had not carried the amount back 5 years for federal purposes.