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:**

Arizona corporate income tax treatment of obligations of the United States Government, federal agencies, and United States Territories.

**APPLICABLE LAW:**

31 United States Code (U.S.C.) § 3124(a) prohibits all states from imposing an income tax on interest income from direct obligations of the United States Government.

Various U.S.C. sections prohibit state taxation of income from certain obligations of United States government sponsored enterprises and agencies and from certain obligations of United States Territories. See Appendix for specific code sections.

Arizona Revised Statutes (A.R.S.) § 43-961(5) disallows deductions when such deductions are allocable to a class of income that is not required to be included in the taxpayer's Arizona adjusted gross income or Arizona taxable income.

A.R.S. § 43-1122(5) provides a subtraction from a corporation’s Arizona gross income for interest income received on obligations of the United States.

**LEGAL REFERENCES:**


*Nebraska Department of Revenue v. Loewenstein*, 513 U.S. 123, 115 S. Ct. 557 (1994), held that 31 U.S.C. § 3124(a) does not prohibit states from taxing interest income derived from repurchase agreements involving United States government obligations.

*Smith v. Davis*, 323 U.S. 111 (1944) sets forth the types of credit instrumentalities that are exempt under 31 USC § 3124(a).

**DISCUSSION:**
Interest Income From Exempt Obligations

Federal law prohibits all states from imposing an income tax on interest income from direct obligations of the United States Government. Additionally, federal law may prohibit state taxation of interest income from the obligations of government-sponsored enterprises and agencies and from the obligations of United States Territories. Exempt interest income that is included in Arizona gross income (Federal adjusted gross income) may be subtracted in computing Arizona adjusted gross income. Part I of the Appendix which is attached to this ruling lists those obligations whose interest income is exempt from Arizona income tax.

Deduction of Related Expenses

Interest or other related expenses incurred to purchase or carry tax exempt obligations cannot be deducted. If such expenses are included in a taxpayer's Arizona gross income, the subtraction of exempt interest must be reduced by the amount of the expenses. If the taxpayer itemizes deductions on his or her Arizona return, the expenses must be excluded from the taxpayer's Arizona itemized deductions.

Gain on Sale

Any gain recognized for federal income tax purposes on the sale of United States bonds and notes or other tax exempt obligations is not considered to be interest on such obligations and is subject to Arizona income tax.

Repurchase Agreements

Interest from Repurchase Agreements involving United States government obligations is not exempt and is subject to Arizona income tax.

Interest Income From Taxable Obligations

There are a number of obligations that are issued under the authority of an act of Congress which are subject to Arizona income tax. These obligations may be guaranteed by the United States Treasury or supported by the issuing agency’s right to borrow from the Treasury while other obligations may be backed by the pledge of full faith and credit of the United States Government. However, these obligations are not direct obligations of the United States Government to pay a specified sum at a specified date nor is the interest from these obligations specifically exempt from state taxation by the respective authorizing acts. Therefore, interest income from such obligations is subject to Arizona income tax. Part II of the Appendix lists some obligations that are subject to Arizona income tax.

RULING:
Interest income received from the obligations listed in Part I of the Appendix which is attached to this ruling is exempt from Arizona income tax.

Interest or other related expenses incurred to purchase or carry tax exempt obligations cannot be deducted. If such expenses are included in a taxpayer's Arizona gross income, the subtraction of exempt interest must be reduced by the amount of the expenses. If the taxpayer itemizes deductions on the taxpayer's Arizona return, the expenses must be excluded from the taxpayer's Arizona itemized deductions.

Any gain recognized for federal income tax purposes on the sale of United States bonds and notes or other tax exempt obligations is subject to Arizona income tax.

Interest income received from repurchase agreements involving United States government obligations is subject to Arizona income tax.

Interest income received from the obligations listed in Part II of the Appendix is subject to Arizona income tax.

J. Elliott Hibbs, Director

Date

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.
APPENDIX
TO
ARIZONA GENERAL TAX RULING
GTR 04-___

PART I. TAX EXEMPT OBLIGATIONS

A. United States Government Obligations


Note: Interest from zero coupon obligations issued by the United States Government ("STRIPS") is exempt from Arizona income tax. Interest from proprietary receipts ("CATS", "STARs", "TIGRs", "Cougars", "Lions", "Zebras", etc.) is also exempt.

   (a) First Series, Series A through E.
   (b) Second Series, Series F.
   (c) Third Series, Series G.
   (d) Fourth Series, Series H and I.

B. Territorial Obligations


APPENDIX

(Continued)


Note: Interest from the foregoing territorial obligations is not currently included in federal adjusted gross income. Therefore, this interest should not be subtracted from Arizona gross income in computing Arizona adjusted gross income. Since the interest is exempt from state income tax under federal law, it is not required to be added to Arizona gross income under A.R.S. § 43-1021(4).

C. Federal Agency Obligations


2. Commodity Credit Corporation - Interest from bonds, notes, debentures, and other similar obligations issued by the Commodity Credit Corporation as set forth in 15 U.S.C. § 713a-5.


4. Federal Deposit Insurance Corporation - Interest from notes, debentures, bonds, or other such obligations issued by the Federal Deposit Insurance Corporation as set forth in 12 U.S.C. § 1825.


12. General Insurance Fund
   (b) Interest from debentures issued by the General Insurance Fund under the War Housing Insurance Law as set forth in 12 U.S.C. § 1739(d).
   (c) Interest from debentures issued by the General Insurance Fund to acquire rental housing projects as set forth in 12 U.S.C. § 1713(l).
   (g) Interest from debentures issued by the General Insurance Fund under the Neighborhood Conservation Housing Insurance Law as set forth in 12 U.S.C. § 1715K.


14. Production Credit Association - Interest from notes, debentures, and other obligations issued by the Production Credit Association as set forth in 12 U.S.C. § 2077.


PART II. TAXABLE OBLIGATIONS

A. Federal Agency Obligations


2. Environmental Financing Authority - Interest from obligations issued by the Environmental Financing Authority as set forth in 33 U.S.C. § 1281.


9. Federal Reserve Bank (FRB) – Income from dividends received by member banks of the Federal Reserve Bank as set forth in 12 USC § 289.


B. Obligations of International Institutions


See Arizona Individual Income Tax Ruling ITR 02-2 for the Arizona income tax treatment of mutual fund dividends derived from interest on federal obligations.

See Arizona Individual Income Tax Ruling ITR 96-3 for the Arizona income tax treatment of pension plan distributions derived from interest on United States government obligations.

See Arizona Individual Income Tax Ruling ITR 96-2 for the Arizona income tax treatment of Individual Retirement Account (IRA) distributions derived from interest on United States government obligations.