

**INCOME TAXATION OF
MULTI-STATE CORPORATIONS**

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1. INTRODUCTION.

This outline focuses on the Arizona Corporate Income Tax and will examine in detail the mechanics of taxing multi-state corporations that conduct business both in Arizona and other states.

This Outline will approach the subject in the following “building-block style.”

- *Structure of Arizona Corporate Income Tax.* To set into focus the taxation of multi-state businesses, we'll first start with an overview of the structure of the Arizona Corporate Income Tax.

- *Corporation Doing Business Only in Arizona.* Next, we will apply the Arizona Corporate Income Tax structure to a Corporate taxpayer that is doing business only in Arizona.

- *Multi-State Corporation.* The Arizona Corporate Income Tax Structure will then be applied to a multi-state corporation that has income from business activities carried on both in Arizona and in other states. The focus of this part of the Outline will be on UDIPTA's formula apportionment methodology.

- *Unitary Group.* Finally, we will turn our attention to the income taxation of a corporate taxpayer that is a part of a larger unitary, corporate group. The focus of this part of the Outline will be on the “Unitary Business” concept.

2. OVERVIEW OF THE ARIZONA CORPORATE INCOME TAX.

2.1 The Arizona Corporate Income Tax Conforms to the Internal Revenue Code.

Arizona has incorporated the Internal Revenue Code of 1986, as amended, in effect on January 1, 1995. See A.R.S. § 43-105. The Internal Revenue Code serves as the "underpinnings" of the Arizona income tax structure, both for corporations and individuals.

2.2 Starting Point: Federal Taxable Income Equals Arizona Gross Income.

The Arizona corporate income tax "piggybacks" or conforms to the federal income tax. The starting point in determining Arizona tax liability is the corporate taxpayer's federal taxable income. Specifically, "Arizona gross income" equals "federal taxable income." A.R.S. § 43-1101.1. NOTE, this is different from the starting point for individual income taxation where Arizona gross income equals Federal adjusted gross income. A.R.S. § 43-1001.2. As a result of starting with federal taxable income, most of the changes made by the Tax Reform Act of 1986 "flow through" to Arizona.

2.3 Federal Consolidated Return.

A corporate taxpayer which has joined in the filing of a federal consolidated return but does not file an Arizona combined return must use a hypothetical starting point for federal taxable income. The starting point will be federal taxable income computed as if the corporation had filed a separate federal income tax return. Department of Revenue Letter to Commerce Clearing House.

2.4 Adjustments to Arizona Gross Income.

Certain adjustments must be made to "Arizona gross income" (federal taxable income) to arrive at "Arizona taxable income." A.R.S. § 43-1101.2. Those adjustments take the form of the additions and subtractions of A.R.S. §§ 43-1121 and 43-1122, respectively, and the other adjustments specified in A.R.S. §§ 43-1123 through 43-1130.01.

2.5 Additions to Arizona Gross Income for Corporations.

A.R.S. § 43-1121 requires that the following items be added to Arizona gross income:

1. The amounts computed pursuant to § 43-1021, paragraphs 4 through 10 and 14.
2. The amount of dividend income received from corporations and allowed as a deduction pursuant to § 243, 244 and 245 of the internal revenue code.
3. Taxes which are based on income paid to states, local governments or foreign governments and which were deducted in computing federal taxable income. (Effective 1/1/98, the subtraction for Arizona corporate income taxes paid was repealed.)
4. Expenses and interest relating to tax-exempt income on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the tax imposed by this title. Financial institutions, as defined in § 6-101, shall be governed by § 43-961, paragraph 2.

5. Commissions, rentals and other amounts paid or accrued to a domestic international sales corporation controlled by the payor corporation if the domestic international sales corporation is not required to report its taxable income to this state because its income is not derived from or attributable to sources within this state. If the domestic international sales corporation is subject to article 4 of this chapter, the department shall prescribe by rule the method of determining the portion of the commissions, rentals and other amounts which are paid or accrued to the controlled domestic international sales corporation and which shall be deducted by the payor. "Control" for purposes of this paragraph means direct or indirect ownership or control of fifty per cent or more of the voting stock of the domestic international sales corporation by the payor corporation.

6. Federal income tax refunds received during the taxable year to the extent they were deducted in arriving at Arizona taxable income in a previous year.

7. The amount of net operating loss taken pursuant to § 172 of the internal revenue code.

8. The amount of exploration expenses determined pursuant to § 617 of the internal revenue code to the extent that they exceed seventy-five thousand dollars and to the extent that the election is made to defer those expenses not in excess of seventy-five thousand dollars.

9. Amortization of costs incurred to install pollution control devices and deducted pursuant to the internal revenue code or the amount of deduction for depreciation taken pursuant to the internal revenue code on pollution control devices for which an election is made pursuant to § 43-1129.

10. The amount of depreciation or amortization of costs of child care facilities deducted pursuant to §§ 167 or 188 of the internal revenue code for which an election is made to amortize pursuant to § 43-1130 or for which a credit is taken under § 43-1163, subsection A, paragraph 1.

11. Arizona state income tax refunds received, to the extent the amount of the refunds is not already included in Arizona gross income, if a tax benefit was derived by deduction of this amount in a prior year.

12. The amount of depreciation or amortization of costs of recycling equipment deducted pursuant to the internal revenue code for which an election is made pursuant to § 43-1164.

13. The amount paid as taxes on property in this state by a qualified defense contractor with respect to which a credit is claimed under § 43-1166.

14. The loss of an insurance company that is exempt under § 43-1201 to the extent that it is included in computing Arizona gross income on a consolidated return pursuant to § 43-947.

15. Any amount of agricultural water conservation expenses that were deducted pursuant to the internal revenue code for which a credit is claimed under § 43-1172.

16. The amount by which the depreciation or amortization computed under the internal revenue code with respect to property for which a credit was taken under § 43-

1169 exceeds the amount of depreciation or amortization computed pursuant to the internal revenue code on the Arizona adjusted basis of the property.

17. The amount by which the adjusted basis computed under the internal revenue code with respect to property for which a credit was claimed under § 43-1169 and which is sold or otherwise disposed of during the taxable year exceeds the adjusted basis of the property computed under § 43-1169.

18. The amount by which the depreciation or amortization computed under the internal revenue code with respect to property for which a credit was taken under § 43-1170 exceeds the amount depreciation or amortization computed pursuant to the internal revenue code on the Arizona adjusted basis of the property.

19. The amount by which the adjusted basis computed under the internal revenue code with respect to property for which a credit was claimed under § 43-1170 and which is sold or otherwise disposed of during the taxable year exceeds the adjusted basis of the property computed under § 43-1170.

20. The deduction referred to in § 1241(a)(4) of the internal revenue code for restoration of a substantial amount held under a claim of right.

21. The amount by which a capital loss carryover allowable pursuant to § 1341(b)(5) of the internal revenue code exceeds the capital loss carryover allowable pursuant to § 43-1130.01, subsection F.

22. Any amount deducted in computing Arizona taxable income as expenses for installing solar stub outs or electric vehicle recharge outlets in this state with respect to which a credit is claimed pursuant to section 43-1176.

23. Any wage expenses deducted pursuant to the internal revenue code for which a credit is claimed under section 43-1175 and representing net increases in qualified employment positions for employment of temporary assistance for needy families recipients.

The additions cross-referenced in A.R.S. § 43-1121.1 (above) follow (§ 43-1021.4 to 10, and 14):

4. The amount of interest income received on obligations of any state, territory or possession of the United States, or any political subdivision thereof, located outside the state of Arizona, reduced, for tax years beginning from and after December 31, 1996, by the amount of any interest on indebtedness and other related expenses that were incurred or continued to purchase or carry those obligations and that are not otherwise deducted or subtracted in arriving at Arizona gross income.

5. Annuity income received during the taxable year to the extent that the sum of the proceeds received from such annuity in all taxable years prior to and including the current taxable year exceeds the total consideration and premiums paid by the taxpayer. This paragraph applies only to those annuities with respect to which the first payment was received prior to December 31, 1978.

6. The excess of a partner's share of partnership taxable income required to be included under chapter 14, article 2 of this title over the income required to be reported under § 702(a)(8) of the internal revenue code.

7. The excess of a partner's share of partnership losses determined pursuant to § 702(a)(8) of the internal revenue code over the losses allowable under chapter 14, article 2 of this title (the partnership tax provisions, A.R.S. §§ 43-1411-1413).

8. The amount by which the adjusted basis of property described in this paragraph and computed pursuant to the internal revenue code exceeds the adjusted basis of such property computed pursuant to this title and the income tax act of 1954, as amended. This paragraph shall apply to all property which is 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.

9. The amount of depreciation or amortization of costs of any capital investment that is deducted pursuant to § 167 or 179 of the internal revenue code by a qualified defense contractor with respect to which an election is made to amortize pursuant to § 43-1024.

10. The amount of gain from the sale or other disposition of a capital investment which a qualified defense contractor has elected to amortize pursuant to § 43-1024.

* * *

14. Any nonitemized amount deducted pursuant to § 170 of the internal revenue code representing contributions to an educational institution which denies admission, enrollment or board and room accommodations on the basis of race, color or ethnic background except those institutions primarily established for the education of American Indians.

2.6 Subtractions From Arizona Gross Income For Corporations.

A.R.S. § 43-1122 requires that the following items be subtracted from Arizona gross income:

1. The amounts computed pursuant to § 43-1022, paragraphs 8 through 15.

2. The amount of dividend income received from Arizona corporations as prescribed by § 43-1128.

3. The amount of Arizona capital loss carryover as defined in § 43-1124 in an amount not to exceed one thousand dollars.

4. With respect to a financial institution as defined in § 6-101, expenses and interest relating to tax-exempt income disallowed pursuant to § 265 of the internal revenue code.

5. Dividends received from another corporation owned or controlled directly or indirectly by a recipient corporation. "Control" for purposes of this paragraph means direct or indirect ownership or control of fifty per cent or more of the voting stock of the payor corporation by the recipient corporation. Dividends shall have the meaning provided in § 316 of the internal revenue code. This subtraction shall apply without regard to the provisions of § 43-961, paragraph 2 and article 4 of this chapter. A corporation that has its commercial domicile, as defined in § 43-1131, in this state may subtract the full amount of the dividends. A corporation that does not have its commercial domicile in this state may subtract:

of the dividends. (a) For its taxable year beginning in 1990, an amount equal to one-half

of the dividends. (b) For taxable years beginning in 1991 and thereafter, the full amount

6. Interest income received on obligations of the United States.

7. The amount of dividend income from foreign corporations.

8. The amount of net operating loss allowed by § 43-1123.

9. The amount of any income tax refunds received from states other than Arizona which were included as income in computing federal taxable income.

10. The amount of expense recapture included in income pursuant to § 617 of the internal revenue code for mine exploration expenses.

11. The amount of deferred exploration expenses allowed by § 43-1127.

12. The amount of exploration expenses related to the exploration of oil, gas or geothermal resources, computed in the same manner and on the same basis as a deduction for mine exploration pursuant to § 617 of the internal revenue code. This computation is subject to the adjustments contained in § 43-1121, paragraph 8 and paragraphs 10 and 11 of this section relating to exploration expenses.

13. The amortization of pollution control devices allowed by § 43-1129.

14. The amount of amortization of the cost of child care facilities pursuant to § 43-1130.

15. The amount of income from a domestic international sales corporation required to be included in the income of its shareholders pursuant to § 995 of the internal revenue code.

16. The amount authorized by § 43-1128.01 for the taxable year for purchases of, and equipment relating to, alternative fuel vehicles.

17. The income of an insurance company that is exempt under § 43-1201 to the extent that it is included in computing Arizona gross income on a consolidated return pursuant to § 43-947.

18. The amount of contributions by the taxpayer during the taxable year to individual medical savings accounts established on behalf of the taxpayer's employees pursuant to, and subject to the limitations prescribed by, § 43-1028, to the extent that the contributions are not deductible under the internal revenue code.

19. The amount by which a capital loss carryover allowable pursuant to § 43-1130.01, subsection F exceeds the capital loss carryover allowable pursuant to § 1341(b)(5) of the internal revenue code.

* * *

The subtractions cross-referenced in A.R.S. § 43-1122.1 (above) follow (§ 43-1022.8 to 15):

8. Annuity income included in federal adjusted gross income pursuant to § 72 of the internal revenue code if the first payment with respect to such annuity was received prior to December 31, 1978.

9. The excess of a partner's share of income required to be included under § 702(a)(8) of the internal revenue code over the income required to be included under chapter 14, article 2 of this title.

10. The excess of a partner's share of partnership losses determined pursuant to chapter 14, article 2 of this title over the losses allowable under § 702(a)(8) of the internal revenue code.

11. The amount by which the adjusted basis of property described in this paragraph and computed pursuant to this title and the income tax act of 1954, as amended, exceeds the adjusted basis of such property computed pursuant to the internal revenue code. This paragraph shall apply to all property which is held for the production of income and which is sold or otherwise disposed of during the taxable year other than depreciable property used in a trade or business.

12. The amount allowed by § 43-1024 for amortization, by a qualified defense contractor certified by the department of commerce under § 41-1508, of a capital investment for private commercial activities.

13. The amount of gain included in federal adjusted gross income on the sale or other disposition of a capital investment that a qualified defense contractor has elected to amortize pursuant to § 43-1024.

14. The amount allowed by § 43-1025 for contributions during the taxable year of agricultural crops to charitable organizations.

15. The portion of any wages or salaries paid or incurred by the taxpayer for the taxable year that is equal to the amount of the federal work opportunity credit, the empowerment zone employment credit, the credit for employer paid social security taxes on employee cash tips and the Indian employment credit that the taxpayer received under sections 45A, 45B, 51(a) and 1396 of the internal revenue code.

2.7 Other Adjustments.

After the additions and subtractions listed above, A.R.S. § 43-1101.2 requires that Arizona gross income be adjusted by the modifications specified in A.R.S. §§ 43-1123 through 43-1130.01. They are:

- (1) 43-1123. Net operating loss (five-year carryover for NOLs).
- (2) 43-1124. Arizona capital loss carryover existing at the beginning of the taxable year for tax years beginning prior to January 1, 1988.
- (3) 43-1125. Domestic international sales corporation (a DISC is taxed as a regular corporation without regard to the provisions of § 991 through 996 of the internal revenue code).

(4) 43-1126. Small business corporation (an "S" corporation is not subject to corporate income taxation but only to the extent that such a corporation is not subject to federal income taxes).

(5) 43-1127. Deferred exploration expenses (the amount of exploration expenses added pursuant to § 43-1121.8 may be subtracted on a ratable basis as the units of produced ores or minerals discovered or explored are sold).

(6) 43-1128. Subtraction for dividends received from Arizona corporations.

(7) 43-1128.01. Subtraction for alternative fuel vehicles and equipment.

(8) 43-1129. Amortization of expenses incurred in acquisition of pollution control devices.

(9) 43-1130. Amortization of the cost of child care facilities.

(10) 43-1130.01. Restoration of a substantial amount held under claim of right.

2.8 *Arizona Taxable Income.*

After making the additions of A.R.S. § 43-1121, the subtractions of A.R.S. § 43-1122, and the other adjustments of A.R.S. § 43-1123 through 1130.01, the result is Arizona taxable income. *See* A.R.S. § 43-1101.2.

2.9 *Corporate Income Tax Rates and Minimum Tax (A.R.S. § 43-1111).*

Effective for tax years beginning from and after December 31, 1999, A.R.S. § 43-1111 provides for a flat rate tax of 7.968% or \$50, whichever is greater. However, the minimum tax is imposed on an S corporation when the S corporation itself is subject to tax, and on a tax exempt organization which has unrelated business income.

Corporate Income Tax Rate Reduction. The corporate income tax rate was reduced from 9% to 8% effective for tax years beginning from and after December 31, 1997. In conjunction with the rate reduction, the deduction for Arizona corporate income taxes paid was repealed, which makes the effective rate reduction only 0.25%. The deduction for state income taxes paid had effectively decreased the liability for corporations by 0.75%. Additionally, as a part of the corporate tax rate reduction, the throw back provision of the sales factor for sales made to the United States government and to non-taxable states and countries was repealed. *See* Tax Relief Act of 1998, Laws 1998, 4 Special Session, ch. 3.

For the 2001 tax year (tax years beginning from and after December 31, 2000), the rate is reduced to 7%.

2.10 *Alternative Tax For Capital Gains Repealed Effective For Tax Years Ending On Or After 7/1/88.*

Effective January 22, 1986, Arizona implemented an alternative tax for corporations with net capital gains. For a corporation having a net capital gain the alternative tax will be imposed if it is less than the tax computed using the rates indicated above. The alternative tax consists of the sum of:

(1) The tax on Arizona taxable income reduced by the amount of the net capital gain at the rates indicated above; and

(2) The tax on the amount of net capital gain at the rate of 6.4% of such amount.

Repeal. The preferential tax rate on corporate capital gains was repealed, effective for tax years ending on or after July 1, 1988, by S.B. 1261.

Dividends from Controlled Domestic Corporations.

The subtraction for dividend income received from controlled domestic corporations was formerly allowed only if the recipient corporation had its commercial domicile within Arizona. The statute (A.R.S. § 43-1122.5) has been amended to allow the subtraction as follows:

5. Dividends received from another corporation owned or controlled directly or indirectly by a recipient corporation. "Control" for purposes of this paragraph means direct or indirect ownership or control of fifty percent or more of the voting stock of the payor corporation by the recipient corporation. Dividends shall have the meaning provided in section 316 of the internal revenue code. This subtraction shall apply without regard to the provisions of section 43-961, paragraph 2 and article 4 of this chapter. A corporation that has its commercial domicile, as defined in section 43-1131, in this state may subtract the full amount of the dividends. A corporation that does not have its commercial domicile in this state may subtract:

(a) For its taxable year beginning in 1990, an amount equal to one-half of the dividends.

(b) For taxable years beginning in 1991 and thereafter, the full amount of the dividends.

2.12 Subtraction For Dividends Received From Arizona Corporations.

A.R.S. § 43-1128 provides a subtraction for dividends received from an Arizona corporation, computed as follows:

A. In computing Arizona taxable income, there shall be allowed a subtraction from Arizona gross income for dividends received from a corporation the income of which is subject to taxation under this title, which corporation has filed a report of income as required by this title and the principal business of which is attributable to Arizona. For the purpose of this section, the principal business of a corporation shall be considered attributable to Arizona if fifty per cent or more of the entire taxable income or loss of the corporation, after an adjustment for taxes has been made for the year preceding the payment of such dividends, was used in computing the Arizona taxable income provided by this title.

B. This section does not apply to a dividend received from a business trust which qualifies as a "real estate investment trust" under §§ 856, 857 and 858 of the United States Internal Revenue Code and which is entitled to a deduction under § 857(b) of the Internal Revenue Code.

This subtraction used to apply also to individual recipients, but for 1990 and thereafter it applies only to corporate recipients.

2.13 Income Tax Credits.

The Arizona individual and corporate income tax is “piggy-backed” on the federal income tax. As such, a convenient way for the Arizona Legislature to provide income tax incentives is by the way of state tax credits, rather than through deductions. Following is an overview of the corporate income tax credits currently in place in Arizona.

(1) *Credit for Increased Employment in Enterprise Zones.* Credit for increased employment by a business located in an enterprise zone. A.R.S. § 43-1161.

(2) *Credit for Investment or Employment on Grounds of Correctional Facilities.* Credit for the investment in certain types of property or the employment of inmates on the grounds of a correctional facility. A.R.S. § 43-1162; repealed effective January 1, 2000.

(3) *Credit for Dependent Day Care Facilities.* Credit for expenses for providing dependent care services for employees. A.R.S. § 43-1163; repealed effective January 1, 2000.

(4) *Recycling Equipment Tax Credit.* Credit for placing recycling equipment in service. A.R.S. § 43-1164; repealed effective January 1, 2000.

(5) *Credit for Employment by Qualified Defense Contractor.* Credit for increases in private commercial employment by a defense contractor pursuant to a Department of Defense contract. A.R.S. § 43-1165.

(6) *Credit for Property Taxes Paid by a Qualified Defense Contractor.* Credit for income taxes equal to a portion of the amount paid as property taxes by a qualified defense contractor. A.R.S. § 43-1166.

(7) *Credit for Increased Employment in Military Reuse Zones.* Credit for taxes for net increases in employment of full time employees working in the military reuse zone who are primarily engaged in providing aviation or aerospace services or in the manufacturing of aviation or aerospace products. A.R.S. § 43-1167.

(8) *Research and Development Expenses.* Credit for research and development expenses allowed by I.R.C. § 41, with certain limitations (the limitations are being phased out). A.R.S. § 43-1168. The credit also applies to pass-through entities.

(9) *Credit for Construction Costs of Qualified Environmental Technology Facilities.* Credit for expenses incurred in constructing facilities that manufacture, produce or process solar and other renewable energy products or products from recycled materials. A.R.S. § 43-1169.

(10) *Credit for Pollution Control Equipment.* Credit for 10% of the purchase price of real or personal property that is used to control or prevent pollution. A.R.S. § 43-1170.

(11) *Credit for Agricultural Pollution Control Equipment.* Credit for expenses for pollution equipment used in the commercial production of livestock, livestock products or agricultural, horticultural, viticultural or floricultural crops or products. The credit is equal to 25% of the cost of the pollution control equipment, with a cap of \$25,000 per year. A.R.S. § 43-1170.01. This credit applies to taxable years beginning January 1, 1999.

(12) *Credit for Construction Materials Incorporated into Qualifying Facility.* Credit for construction materials incorporated into buildings or structures predominantly used for manufacturing, fabricating, mining, refining or metallurgical operations, or research and development as defined in A.R.S. § 43-1168, above. A.R.S. § 43-1171; repealed effective January 1, 2000.

(13) *Credit for Agricultural Water Conservation System.* Credit for water conservation system designed to conserve water on the taxpayer's land used to produce agricultural products, raise, harvest or grow trees or sustain livestock. A.R.S. § 43-1172; repealed effective January 1, 2000.

(14) *Credit for Corrective Action Costs for Underground Storage Tanks.* Credit for expenses incurred by a taxpayer that is not liable or responsible for correcting underground storage tanks. A.R.S. § 43-1173.

(15) *Credit for New Alternative Fuel Vehicles and Equipment.* Credit for purchases of alternative fuel vehicles or expenses for converting conventional vehicles into alternative fuel vehicles or purchases of alternative fuel delivery systems, including storage tanks. This credit is in lieu of the subtraction at A.R.S. § 43-1128.01, allowing a subtraction for essentially the same types of equipment. A.R.S. § 43-1174. This credit applies to taxable years beginning January 1, 1999.

(16) *Credit for Vehicle Refueling Apparatus for Electric and Natural Gas Operated Vehicles.* Credit for the purchase of vehicle refueling apparatus for electric or natural gas operated vehicles, including storage tanks, for installation on one or more properties located in Arizona for the taxpayer's use. A.R.S. § 43-1174.01. This credit applies to taxable years beginning January 1, 1999.

(17) *Credit for Alternative Fuel Delivery Systems.* Credit for costs of constructing or operating an alternative fuel delivery system in Arizona that is capable of dispensing an alternative fuel (electricity or natural gas) to an alternative fuel vehicle. A.R.S. § 43-1174.02. This credit applies to taxable years beginning January 1, 1998.

(18) *Credit for Employment of Temporary Assistance for Needy Families Recipients.* Credit for net increases in qualified employment for recipients of the temporary assistance for needy families as defined in § 46-101 who are residents of Arizona. A.R.S. § 43-1175. This credit is effective for years beginning January 1, 1998.

(19) *Credit for Solar Hot Water Heater Plumbing Stub Outs and Electric Vehicle Recharge Outlets Installed in Houses Constructed by Taxpayer.* Credit for costs incurred for installing or including in one or more houses or dwelling units located in Arizona and constructed by the taxpayer one or more solar hot water plumbing stub outs and electric vehicle recharge outlets. The contractor may elect to transfer this credit to a purchaser or transferee of the house or dwelling unit. A.R.S. § 43-1176. This credit applies to taxable years beginning January 1, 1998.

(20) *Credit for Donation of Motor Vehicle to Wheels to Work Program.* The credit is for the fair market value of a vehicle, up to \$1,500 per vehicle, donated to the "Wheels to Work" program. The credits are in lieu of any deduction allowed pursuant to § 170 of the Internal Revenue Code and taken for state tax purposes. A.R.S. § 43-1177. This credit applies to taxable years beginning January 1, 1999.

(21) *Credit for Transaction Privilege Taxes Paid on Purchase of Coal Used in Generating Electricity.* Credit for a taxpayer that purchases coal consumed in generating electrical power. The credit is equal to 35% of the amount of the transaction

privilege tax or use tax paid with respect to the purchase of the coal. The credit may be carried forward for 5 consecutive years and is in lieu of any deduction for state tax purposes for expenses allowed by the Internal Revenue Code. A.R.S. § 43-1178. This credit applies retroactively to taxable years beginning January 1, 1998.

2.14 *Prior Credits -- Now No Longer Available.*

Other credits were allowed against corporate tax liability for certain prior tax years. They were:

(1) *Residential Solar Energy Devices.* Credit for solar devices installed in houses. Former A.R.S. § 43-1161. NOTE, this credit was repealed by Laws 1982, 6 S.S., ch. 2, sec. 7 effective January 1, 1988.

(2) *Commercial Solar Energy Devices.* Commercial solar application credit. Former A.R.S. § 43-1162. NOTE, this credit was repealed by Laws 1982, 6 S.S., ch. 2, sec. 7 effective January 1, 1988.

(3) *Point of Sale Equipment.* Credit for point of sale equipment (cash registers that ring taxable and nontaxable items). Former A.R.S. § 43-1163. NOTE, this credit applies only to point of sale equipment ordered from and after May 31, 1979 and before January 1, 1983.

(4) *Groundwater Measuring Devices.* Credit for groundwater measuring devices. Former A.R.S. § 43-1164. NOTE, this credit is effective for tax years beginning January 1, 1983 and was repealed effective January 1, 1987.

2.15 *The Role of Foreign Tax Credits and Investment Tax Credits In the Federal Income Tax Deduction.*

Former A.R.S. § 43-1122.1 allowed a subtraction for the "amount of any federal income taxes paid, accrued or withheld during the taxable year." How is that deduction computed when the Arizona corporation is a part of a consolidated group for federal income tax filing purposes and the consolidated group has investment tax credit and foreign tax credit? This has been a thorny issue in the sides of both taxpayers and the Department of Revenue over the last several years. The issue has finally been resolved by the Arizona Supreme Court in *State of Arizona, ex rel., Arizona Department of Revenue v. Arizona Sand and Rock Company*, 155 Ariz. 58, 745 P.2d 116 (1987). In that case, the following simplified formula was established for computing the federal income tax deduction:

CHART NO. 1

ARIZONA SAND AND ROCK FORMULA FOR
FEDERAL INCOME TAX DEDUCTION

$$\boxed{\text{FIT Deduction}} = \boxed{\text{Net Tax Liability (Net of all credits)}} \times \boxed{\text{Net-to-Net Ratio}}$$

The net tax liability is federal consolidated net tax liability, net of all credits, including investment tax credits, the win credit, foreign tax credits, etc. It is the figure from line 31 on the Federal Form 1120. The "net-to-net ratio" is a fraction, the numerator being net Arizona income of gain companies only, with the denominator being total net income of gain companies only. The "net-to-net ratio" was given the blessing of the Arizona Court of

Appeals in *Motorola Inc. v. Arizona Department of Revenue*, 143 Ariz. 491, 694 P.2d 321 (App. 1984).

The *Arizona Sand and Rock* formula overturns a prior Arizona Supreme Court case captioned *Arizona Department of Revenue v. Transamerica Insurance Co.*, 124 Ariz. 417, 604 P.2d 1128 (1979). The *Transamerica* case allowed an add-back to net consolidated tax liability of investment tax credits attributable to "non-Arizona" income. The *Arizona Sand and Rock* formula allows no such add-back; the new formula takes all tax credits (except foreign tax credits) out of the federal income tax deduction computation altogether.

If the consolidated group has foreign tax credits, under *Arizona Sand and Rock*, the foreign tax credit amounts is added back to the net tax liability. This is in accord with *Anderson, Clayton and Company v. DeWitt*, 20 Ariz., App. 474, 513 P.2d 1357 (1973)) which allowed a full add-back of foreign tax credits to the net consolidated tax liability for foreign tax credits. It should be noted that it is the Department's position that the foreign tax credit amounts that are added back are net of the foreign tax credit amounts subtracted under A.R.S. § 42-1122.4. That Section allows a subtraction for foreign tax credits used to offset federal income tax liability pursuant to §§ 901-908 of the Internal Revenue Code unless the credits are attributable to non-taxable income or nonapportionable income not allocated to this state. However, the *Anderson Clayton* case doesn't mention any netting, but allows a full add-back of all foreign tax credits (although it should be recognized that the *Anderson Clayton* decision was rendered before A.R.S. § 43-1122.4 was added).

Note: *Deduction for Federal Income Taxes Repealed Effective for 1990 tax year.* The subtraction for the amount of federal income taxes paid or accrued by the taxpayer during the taxable year has been repealed (A.R.S. § 43-1122, by reference to A.R.S. § 43-1022).

Note: *Subtraction For Foreign Tax Credit Repealed Effective for 1990 Tax Year.*

The subtraction for the amount of the foreign tax credit claimed on the federal tax return of the corporate taxpayer which was related to income taxed by Arizona has been repealed (A.R.S. § 43-1122).

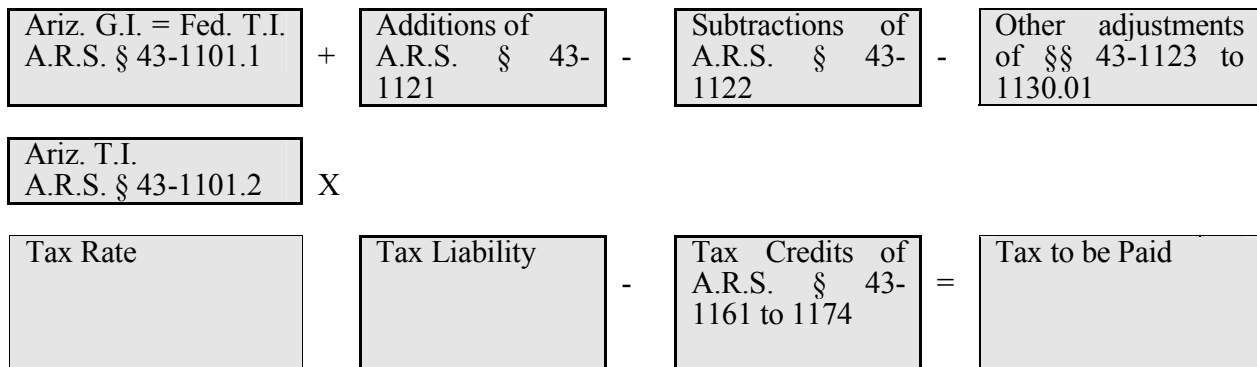
2.16 Flow Chart.

The following "flow chart" illustrates the structure of the Arizona Corporate income tax.

CHART NO. 2

ARIZONA CORPORATE INCOME TAX

FLOW CHART



2.17 Corporations Subject to the Corporate Income Tax.

(1) Corporations with "Arizona Source Income" are taxable.

Every corporation, not expressly exempt, that does business within Arizona or derives income from Arizona sources is subject to the Arizona Corporation Income Tax. A.R.S. § 43-102. The declared legislative intent of the Arizona Income Tax Act of 1978, which includes the Corporate Income Tax Provisions summarized above, is "to impose on . . . each corporation with a business situs in this state a tax measured by taxable income which is the result of activity within or derived from sources within this state." A.R.S. § 43-102.A.5. In turn, A.R.S. § 43-104.9 defines the phrase "income derived from or attributable to sources within the state" to include "income from tangible or intangible property located or having a situs in the state and income from any activities carried on in this state, regardless of whether carried on in intrastate, interstate or foreign commerce."

(2) Tax test is not the same as qualification test. The tests in Arizona for imposing an income tax on either a foreign or domestic corporation is an Arizona business situs and Arizona source income. This test is different from the threshold test for qualification purposes for a foreign corporation, and is not effected by the statutory exemptions from qualification as a foreign corporation under A.R.S. § 10-106.B. The lower standards for taxability could result in a foreign corporation having taxable income in Arizona, although it is not "transacting" business in Arizona within the meaning of the qualification statute. See *Rochester Capital Leasing Corporation v. Sprague*, 13 Ariz. App. 77, 474 P.2d 202 (1970).

2.18 Tax Treatment of "S" Corporations.

"S" corporation income is exempt from the Arizona income tax to the same extent it is exempt from the federal income tax. A.R.S. § 43-1126.A. Prior to 1989, a small

business corporation had to notify the department of its election by filing a copy of its federal election form with the department on or before the date such form is due to the United States Internal Revenue Service. See prior A.R.S. § 43-1126.B. However, that requirement was repealed by Senate Bill 1066, Laws 1989, Chapter 218.

An electing small business corporation must file with the department an annual return, in a form prescribed by the department, on or before the fifteenth day of the third month following the close of the taxable year. The return shall show the name and address of each stockholder of the corporation and their respective pro rata share of income or loss.

The allocation and apportionment of income of a small business corporation which has nonresident stockholders must be made pursuant to Arizona's UDIPTA provisions. A.R.S. § 43-1126.B. An election is effective for the taxable year for which it is made and for all succeeding taxable years unless the corporation terminates its federal election. A.R.S. § 43-1126.B.

Nonresident shareholders of multi-state "S" corporations are subject to the Arizona income tax on their share of the corporation income apportioned to Arizona. Resident "S" corporation shareholders are taxed on their shares of S corporation income, but receive a credit for taxes paid to other states or countries on the same income. A.R.S. § 43-1071. The credit is not allowed if the state or country allows the Arizona resident to claim a credit for taxes paid to Arizona (e.g., California). The credit is limited to the proportion of the tax that income subject to the tax in Arizona and in the other state or country bears to the taxpayer's entire income. A.R.S. § 43-1071.A.3.

Composite returns. In Income Tax Ruling No. 90-1, issued by the Department of Revenue April 12, 1990, the Department indicated that it will accept composite returns filed by S Corporations or partnerships on behalf of qualified non-resident shareholders or partners if the returns meet specific criteria. Members included in the composite return must meet a four-part test, the form of the return must follow Department guidelines, member's deductions, exemptions and liability must be computed separately according to specified rules, and members will be liable for any tax or proposed tax assessment.

To be qualified to be included in a composite return, each members included must be a nonresident of Arizona for the full tax year, have no other Arizona income whether from the member or the member's spouse, must not be a deceased member, and must have the same tax year for income tax purposes. To participate in a composite return, each member must execute, and the corporation must maintain in its files, an affidavit stating that the member is qualified under the four-part test. Also, each member must execute a power of attorney authorizing the composite return by the corporation or partnership on behalf of the nonresident member.

Members included in the composite return must use the standard deduction in lieu of itemized deductions and may not claim tax credits or net operating losses. Also, a composite return may be filed on behalf of some but not all qualifying members, but it must be filed with the participation of at least ten members and any refund must be remitted to the organization for distribution to the members. Persons required to make estimated Arizona tax payments may be included in the return, and changes or corrections may be made only by the corporation's or partnership's filing of an amended composite return. Deductions, exemptions, and tax liability for each member must be calculated by use of the following formula:

(1) The Arizona percentage of a member's total income must be calculated by dividing the amount shown on the member's Arizona nonresident Schedule K-1 by the

member's federal adjusted gross income as shown on the member's individual federal income tax return.

(2) The number of exemptions claimed by the member must be multiplied by the amount allowed for that tax year and then by the Arizona percentage from step (1).

(3) The individual standard deductions are calculated by multiplying the member's allowable standard deduction by the Arizona percentage in step (1), but may exceed the allowable maximum standard deduction for that tax year.

(4) The member's Arizona taxable income is computed by deducting amounts rendered in steps (2) and (3) from Arizona income as shown in the member's nonresident Schedule K-1.

(5) Each member's separate tax liability is then calculated by using the appropriate tax table for that tax year.

(6) In the final step, the aggregate amounts of income, exemptions, deductions and liabilities for all participating members must be reported on the front of the composite return.

If a participating member wants to waive allowable exemptions, subtractions, and deductions, and have the member's tax calculated directly as the member's pro rata share of the entity's income, the member must sign a waiver and file it with the corporation or partnership. Any tax liability of the member included in the composite return may be paid either directly to the Department, to the filing entity, or may be made as a charge against a shareholder's or partner's loan account.

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 return. Extensions of time to file will be granted only on a composite basis, only when a request is made to the Department using the entity's federal identification number, and only when 90% of the composite tax liability is paid prior to the due date for the return using the entity's federal identification number. Individual members are liable for proposed assessments resulting from an audit.

2.19 Limited Liability Companies.

Arizona recognizes the federal "check-the-box rules" of treasury regulation §§ 301.7701-1 to 301.7701-4. The federal tax classification of an entity under the federal "check-the-box rules" determines the entity's classification for Arizona income tax purposes. *See* Corporate Tax Ruling (CTR) 97-1 (July 22, 1997). Thus, whatever classification a limited liability company has elected for federal income tax purposes will control for Arizona income tax purposes.

See also Corporate Tax Ruling (CTR) 97-2 (August 8, 1997). Additionally, if a single member limited liability company is disregarded as an entity separate from its owner for federal income tax purposes, the limited liability company's income will be included in the Arizona tax return of its owner. The classification of a limited liability company for Arizona income tax purposes will apply retroactively from and after December 31, 1996, including limited liability companies that determine their federal tax classification under the "check-the-box rules" before the effective date of the revised Arizona Limited Liability Company Act. *See* CTR 97-2.

2.20 Exempt Organizations.

Types of Exempt Organizations. A.R.S. § 43-1201 lists the various types of tax-exempt organizations. They are, in general, the same as the exemptions from federal income tax provided by Section 501 of the Internal Revenue Code. However, the qualifications pertaining to several categories are different under Arizona law than federal law. A tax-exempt organization may lose its exemption for maintaining unreasonable accumulations of income or engaging in prohibited transactions. A.R.S. § 43-1211. Exempt organizations are subject to a tax on unrelated business income as defined in Section 512 of the Internal Revenue Code. A.R.S. § 43-1231.

2.21 Insurance Companies. Insurance companies that pay a tax on premium income derived from sources within Arizona are exempt from the Corporate Income Tax. A.R.S. § 43-1201.14. A tax on premium income is imposed on foreign and domestic authorized insurers (A.R.S. § 20-224), formerly authorized insurers (A.R.S. § 20-206), surplus line brokers (A.R.S. § 20-416), workers' compensation self-insurers (A.R.S. § 23-961) and health care service organizations (A.R.S. § 20-1060).

2.22 Public Utilities. Public utilities are subject to the Arizona Corporate Income Tax in the same manner as other corporations.

(1) *Accelerated Depreciation For Pollution Control Devices.* In *Tucson Electric Power Company v. Arizona State Department of Revenue*, Arizona Tax Court No. TX 88-00721 (January 15, 1991), the Tax Court held that a utility was not entitled to accelerated depreciation deductions on its 1980 and 1981 Arizona income tax returns for pollution control devices placed in service at the utility's generating stations in New Mexico in 1979, 1980 and 1981, because the utility failed to obtain the Arizona Department of Health Services' certification of the devices as required by former A.R.S. § 43-1030 (currently A.R.S. § 43-1129), and therefore failed to establish that it qualified for the deductions. This result was reached even though the Arizona Department of Health Services refused to certify the pollution control devices because it took the position that it had no authority for such certification for devices located outside the borders of the State of Arizona.

The Tax Court decision was reversed by the Arizona Court of Appeals in *Tucson Electric Power v. Ariz. Dept. of Rev.*, 174 Ariz. 502, 851 P.2d 132 (Ct. App. 1992). Based on estoppel principles, the Court held that because the Department has informed Tucson Electric Power that the depreciation be allowed if its pollution control devices were certified in New Mexico. This ruling is contrary to the general rule of estoppel in Arizona that the Department is not bound by its previous statements even if wrong and if the taxpayer suffers damages as a result. It concluded that since the Department only informed Tucson Electric Power as to a *procedural* matter, *i.e.*, where it should get the devices certified, as opposed to a question of *substantive tax liability*, then the Department would be bound by its previous statements.

The Arizona Supreme Court refused to review the decision.

2.23 Financial Institutions. Financial institutions are subject to the Corporate Income Tax the same as other corporations. *See* A.R.S. § 42-901 and 902. However, they are limited in the amount of interest expense they may deduct (*see* A.R.S. § 43-961.2).

2.24 DISCs. Pre-1985 Domestic International Sales Corporations are subject to Arizona taxation without regard to the special provisions of Sections 991 to 996 of the Internal Revenue Code. A.R.S. § 43-1125.

2.25 *FSCs.* Arizona has no special statutory provisions for taxing foreign sales corporations. However, Arizona Corporate Tax Ruling CTR 98-1 provides that Arizona will not make adjustments to the transactions between a corporation, a valid affiliated foreign sales corporation when computing Arizona taxable income if those transactions meet the applicable federal requirements.

2.26 *Net Operating Loss.*

A.R.S. § 43-1123 details the calculation of a corporation's net operating loss as follows:

A. As used in this section, the term "net operating loss" means:

1. In the case of a taxpayer who has a net operating loss for the taxable year within the meaning of section 172(c) of the internal revenue code, the amount of the net operating loss increased by the subtractions specified in section 43-1122 and reduced by the additions specified in section 43-1121.

2. In the case of a taxpayer not described in paragraph 1 of this subsection, any excess of the subtractions specified in section 43-1122 over the sum of the Arizona gross income plus the additions specified in section 43-1121.

B. If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carryover for each of the five succeeding taxable years, except that the carryover in the case of each such succeeding taxable year, other than the first succeeding taxable year, shall be the excess, if any, of the amount of such net operating loss over the sum of the taxable income for each of the intervening years computed:

1. With the exception prescribed by subsection D.

2. By determining the net operating loss deduction for each intervening taxable year, without regard to such net operating loss or to the net operating loss for any succeeding taxable year and without regard to any reduction specified in subsection C. For the purpose of the preceding sentence, the net operating loss for any taxable year shall be reduced by the amount, if any, of the taxable income for the preceding taxable year computed:

(a) With the exception prescribed by subsection D.

(b) By determining the net operating loss deduction for such preceding taxable year without regard to such net operating loss and without regard to any reduction specified in subsection C.

C. The amount of the net operating loss deduction shall be the aggregate of the net operating loss carryovers to the taxable year reduced by the amount, if any, by which the taxable income computed with the exception prescribed by subsection D exceeds the taxable income computed without such deduction.

D. No net operating loss deduction shall be allowed or included in the computations prescribed by this section.

3. TAXATION OF CORPORATIONS DOING BUSINESS ONLY IN ARIZONA.

3.1 General.

It is a fairly simple procedure to determine the Arizona income tax liability of a corporation which is doing business only in Arizona, with only Arizona source income. The procedure outlined in Chart No. 2, the flowchart for the Arizona Corporate Income Tax, would apply without any adjustments having to be made to factor out income from non-Arizona sources as is the case with multi-state corporations.

3.2 Example.

Assume that Arizona Based Corporation ("ABC Corp.") has federal taxable income of \$100; further assume that it has the following adjustments: additions of \$20 and subtractions of \$30. ABC Corp.'s Arizona taxable income will then be \$90 (\$100 plus \$20 minus \$30 equals \$90). The corporate tax rate will then be applied against that amount to determine ABC Corp.'s Arizona corporate tax liability.

4. TAXATION OF MULTI-STATE CORPORATIONS--GENERAL.

4.1 Limitation Imposed by the Due Process and Commerce Clause.

(1) *Due Process Clause* – “*Minimum Connection.*” The Due Process Clause of the 14th Amendment of the U.S. Constitution imposes a two-part test for a state to impose a net income tax: (1) no tax may be imposed unless there is some minimal connection between the activities of the taxpayer and the taxing state; and (2) the income attributed to the taxing state must be rationally related to values connected with the state imposing the tax. *Exxon Corp. v. Department of Revenue*, 100 S. Ct. 2109 (1980); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 100 S. Ct. 1223 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S. Ct. 2340 (1978), *reh'g denied*, 439 U.S. 885, 99 S. Ct. 233.

(2) *Commerce Clause* – “*Four Part Test*” of *Complete Auto Transit*. The Commerce Clause also restricts a state's ability to impose an income tax on a multi-state corporation. In addition to restricting a state's ability to tax income derived from interstate commerce (such a tax can't unduly burden interstate commerce), the Commerce Clause also requires that a state's tax be imposed only on activities that have a substantial "nexus" with the taxing state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 279, 97 S. Ct. 1076 (1977).

Under *Complete Auto*, a tax on interstate commerce is constitutional if it meets the following four-part test:

1. The tax is applied to an activity with a substantial nexus to the taxing state;
2. the tax is fairly apportioned;
3. the tax does not discriminate against interstate commerce; and
4. the tax is fairly related to the services provided by the state.

4.2 *Determining a Multi-State Corporation's In-State Income.*

(1) *General.*

In light of the restrictions imposed by the Due Process and Commerce Clauses of the U.S. Constitution, it is necessary to determine what portion of a multi-state corporation's income is derived from in-state sources."

In complying with the Due Process and Commerce Clause restrictions, the states use two basic methods for determining the income a multi-state corporation earns within their borders: separate accounting and formula apportionment.

(2) *Separate Accounting.* Separate accounting, used less frequently than formula apportionment, is sometimes applied when a business is able to accurately separate income-producing activities and income sources within a particular state from income-producing activities and income sources in other states. This state-by-state determination requires verifying numerous intercorporate transactions to compute the proper value for goods and services exchanged between the related entities. This is a time-consuming task, involving the potential for thousands of transactions. State tax administrators and corporate taxpayers generally agree that under the separate accounting method:

(1) the cost of preparing tax returns and the time required to audit those returns is generally greater;

(2) the allocation of indirect expenses--such as advertising costs--among the corporate entities is based on arbitrary criteria which can vary from one corporation to another; and

(3) the determination of fair and reasonable selling prices for goods exchanged between corporate entities is difficult.

Because of these difficulties and doubts about the applicability of separate accounting to some types of businesses, the states generally use separate accounting only to determine the income certain kinds of multi-state corporations earned within their jurisdictions. These businesses, primarily general merchandising, oil and gas, and construction companies, use separate accounting because it conforms more to their financial accounting procedures and more accurately reflects income than formula apportionment. For example, a construction firm normally determines profitability on an individual project basis, calculating revenues and costs separately for each project. *See* General Accounting Office, Report to the Chairman, House Committee on Ways and Means, "Key Issues Affecting State Taxation of Multi-State Jurisdictional Corporate Income Need Resolving," July 1, 1982, pages 2 and 3 (the "GAO Report").

(3) *Formula Apportionment.* All 45 states which impose an income tax rely primarily on formulas to apportion a corporation's income among those states in which the corporation does business. Apportionment formulas attribute income to the states on the basis of factors which produce the income. The factors most commonly used are property, payroll and sales. To derive the amount of income taxable in the state, the

value of each factor in a state is first compared to the total value of that factor for the corporation. The formula used by most is:¹

CHART NO. 3

THREE FACTOR FORMULA

$\frac{\text{In-State property}}{\text{Total Property}} + \frac{\text{In-State payroll}}{\text{Total Payroll}} + \frac{\text{In-State sales}}{\text{Total sales}}$	X	$\text{Total corporate income}$	=	$\text{Income taxable by the State}$
3				

When required by a state to use formula apportionment, a multi-state corporation usually begins by adjusting its federal taxable income for items which the state treats differently from federal law (e.g. the additions and subtractions required by A.R.S. § 42-1121 and 1122) and for income items not subject to the apportionment formula. The types and amounts of income not subject to formula apportionment, such as dividends and interest, vary among the states. Those income items which are not apportioned among the states are normally taxed and totaled by one state. This procedure is known as "allocation" -- that is, the total amount of these income items is allocated to one state. Depending on the individual state rules, the state to which the income is allocated may be determined by the location of: (1) the corporate headquarters, (2) the assets producing the income, (3) the activity producing the income, or (4) the entity which paid income to the taxpayer.

Once a corporation determines the income to be apportioned, it applies a formula, such as the one shown above, to that income to calculate the amount to be apportioned to an individual state. Under the formula apportionment method, the multi-state corporation's income a state may tax consists of the income specifically allocated to the state *plus* the income derived from application of the apportionment formula.

Note, however, that the states do not apply the formula apportionment in all cases. In order to properly apply formula apportionment, the business operation of the corporation, both within the state and outside the state, must be "unitary." A unitary business may be comprised of branches or divisions of a single corporation or commonly controlled but separate corporations. The criteria usually applied for determining if the operations of a business are unitary include: the percentage of one corporation's stock owned by another; the sharing of centralized services, such as accounting and advertising; and the type and number of transactions carried out between corporate entities (the "unitary" concept is covered in detail in Section 5 of this Outline). See GAO Report pages 3 and 4.

4.3 *Constitutionality of Apportionment Formulas.*

Several U.S. Supreme Court cases have addressed whether apportionment formulas comply with the due process or commerce clause provisions. Generally, the cases have upheld the challenged formulas and allowed even single factor formulas to be used to apportion tax to the particular state.

¹ Arizona double weights the sales factor, otherwise Arizona's formula is the same. See A.R.S. § 43-1139.

In *Underwood Typewriter v. Chamberlain*, 254 U.S. 113 (1920) the State of Connecticut used a single apportionment factor, the property factor, to allocate 47% of Underwood's income to Connecticut even though only 3% of its income was generated by transactions in Connecticut. The Court upheld the use of the single factor as constitutional. The Court also upheld use of a single factor apportionment formula in *Bask, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924).

However, the use of a single factor was overturned in *Hans Rees' Sons, Inc. v. State of North Carolina*, 283 U.S. 123, 51 S.Ct. 385 (1931), where the Court found that a roughly 60% disparity between the income found to be North Carolina source and the income allocated to North Carolina by the single factor, was arbitrary and unreasonable. The Court said:

Nor can the evidence be put aside in the view that it merely discloses such negligible criticisms in allocation of income as are inseparable from the practical administration of a taxing system in which apportionment with mathematical exactness is impossible. The evidence in this instance, as the state court puts it, "tends to show that for the year 1923, 1924, 1925, and 1926, the average income having its source in the manufacturing and tanning operations with the State of North Carolina was seventeen percent," while under the assessments in question there was allocated to the State of North Carolina approximately 80 percent of the appellant's income . . . It is sufficient to say that, in any aspect of the evidence, and upon the assumption made by the state court with respect to the facts shown, the statutory method, as applied to the appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state. In this view, the taxes as laid were beyond the state's authority.

283 U.S. at 134, 136, 51 S. Ct. at 389.

The general standard for evaluating the representativeness of an apportionment formula was articulated in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 103 S. Ct. 2933 (1983) where the Court stated as follows:

Having determined that a certain set of activities constitute a "unitary business," a State must then apply a formula apportioning the income of that business within and without the State. Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. [citations omitted]. . . The second and more difficult requirement is what might be called external consistency - the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated . . . Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove by "'clear and cogent' evidence that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State' [*Hans Rees' Sons, Inc.*], 283 U.S. at 135, 51 S. Ct. at 389, or has 'led to a grossly distorted result,' [*Norfolk & Western R. Co. v. State Tax Comm'n*], 390 U.S. 317, 326, 88 S. Ct. 995, 101, 19 L. Ed. 2d 1201 (1968)." *Moorman Mfg. Co.*, [437 U.S. 267, 274, 98 S. Ct. 2340, 2345].

463 U.S. at 169-70, 103 S. Ct. at 2942.

In the *Moorman Manufacturing Co. v. Bair*, 431 U.S. 267 (1978), the Court again upheld a single factor apportionment formula this time only using sales.

5. TAXATION OF A MULTI-STATE CORPORATION BY ARIZONA--FORMULA APPORTIONMENT AND UDIPTA.

5.1 *Only "Arizona Source Income" is Taxed.*

In addition to Commerce and Due Process Clause restrictions, the Arizona Legislature declared its intent in A.R.S. § 43-102.A.5 "to impose on . . . each corporation with a business situs in this state a tax measured by taxable income which is the result of activity within or derived from sources within this state." In turn, A.R.S. § 43-104.9 defines the phrase "income derived from or attributable to sources within this state" to include "income from tangible or intangible property located or having a situs in this state and income from any activities carried on in this state, regardless of whether carried in intrastate, interstate or foreign commerce." Thus, Arizona is restricted by not only the Commerce and Due Process clauses, but by statute to taxing only in-state income.

5.2 *Arizona Uses The Formula Apportionment of "UDIPTA to Determine In-State Income."*

When a multi-state corporation is doing business both within and without Arizona, Arizona uses the formula apportionment method to determine the multi-state corporation's Arizona source income subject to Arizona taxation. Arizona has adopted the three-factor formula apportionment methodology provided by the Uniform Division of Income for Tax Purposes Act ("UDIPTA"). UDIPTA is a uniform law which has been adopted by 24 states. Arizona adopted it in 1983 and it became effective for all tax years beginning from and after December 31, 1983. UDIPTA is found at A.R.S. § 43-1131 through 1150. The following portion of the Outline discusses the Uniform Division of Income for Tax Purposes Act.

5.3 *Taxpayers Subject to UDIPTA.*

(1) *General.*

UDIPTA applies to any taxpayer who has income from business activity which is taxable both within and without the State of Arizona. A.R.S. § 43-1131.7 and 43-1132. It applies to corporations, partnerships and sole proprietorships. The form of the business is not a factor.

(2) *Public Utilities and Financial Institutions.*

The Uniform Act excludes public utilities and financial institutions from the allocation and apportionment provisions of UDIPTA. However, Arizona's current version of UDIPTA applies to both to financial institutions and public utilities. A.R.S. § 43-1132.A and Section 2 of UDIPTA.

5.4 *UDIPTA's Purpose.*

UDIPTA's purpose is to ensure that 100% of a business's income (*no more and no less*) is taxed by the various states (that have income taxes) in which the taxpayer conducts its business. UDIPTA is meant to avoid the situations where a taxpayer (1) will only be taxed on less than the full 100% of its total income by the various states (which have income taxes) in which the taxpayer conducts business; or (2) will be taxed on more than 100% of its total income by the various states (which have income taxes) in which the taxpayer conducts business.

5.5 *How UDIPTA is Structured to Accomplish Its Purpose.*

UDIPTA divides a business's income into "business income" and "nonbusiness income." "Nonbusiness income" is specifically allocated to a particular state. "Business income," on the other hand, is apportioned using the "three-factor formula" to the states the taxpayer is doing business in.

5.6 *Specific Allocation of "Nonbusiness Income."*

(1) *Definition of "Nonbusiness Income."*

"Nonbusiness income" means "all income other than business income." A.R.S. § 43-1131.4.

(2) *General Rule--Allocate Nonbusiness Income.*

Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute non-business income, are allocated as specifically provided for by UDIPTA (see the following subsections). A.R.S. § 43-1134.

(3) *Net Rents and Royalties.*

Real Property. Net rents and royalties from real property located in Arizona are allocable to Arizona. A.R.S. § 43-1135.A.

Personal Property. Net rents and royalties from tangible personal property are allocable to Arizona either: (1) If and to the extent the properties are utilized in Arizona. (2) In their entirety if the taxpayer's commercial domicile is in Arizona and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized. A.R.S. § 43-1135.B.

Utilization of Personal Property in a State. The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rent or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession. A.R.S. § 43-1135.C.

(4) *Capital Gains and Losses.*

Real Property. Capital gains and losses from sales of real property located in Arizona are allocable to Arizona. A.R.S. § 43-1136.A.

Tangible Personal Property. Capital gains and losses from the sales of tangible personal property are allocable to Arizona if either:

(1) The property had a situs in Arizona at the time of the sale.

(2) The taxpayer's commercial domicile is in Arizona and the taxpayer is not taxable in the state in which the property had a situs. A.R.S. § 43-1136.B.

Intangible Personal Property. Capital gains and losses from the sales of intangible personal property are allocable to Arizona if the taxpayer's commercial domicile is in Arizona. A.R.S. § 43-1136.C.

(5) *Interest and Dividends.*

Interest and dividends are allocable to Arizona if the taxpayer's commercial domicile is in Arizona unless the interest or dividend constitutes business income. A.R.S. § 43-1137.

(6) *Patent and Copyright Royalties.*

General Rule. Patent and copyright royalties are allocable to Arizona either:

(1) if and to the extent that the patent or copyright is utilized by the payer in Arizona;

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in Arizona. A.R.S. § 43-1138.A.

Utilization Of Patent in a State. A patent is utilized in a state to the extent that it is employed in production, in fabrication, manufacturing or the processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located. A.R.S. § 43-1138.B.

Utilization of Copyright in a State. A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocations to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located. A.R.S. § 43-1138.

5.7 *Apportionment of Business Income.*

(1) *Definition of "Business Income."*

"Business income" means "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." A.R.S. § 43-1131.1.

(2) *Rule--Apportion Business Income.*

All business income is to be apportioned to Arizona by multiplying the income by a fraction, the numerator of which is a property factor plus the payroll factor plus the sales factor and the denominator of which is three. A.R.S. § 43-1139.

(3) *Formula.*

The apportionment formula is generally referred to as the "three-factor formula":

CHART NO. 4

THREE FACTOR FORMULA

$$\frac{\text{Arizona property}}{\text{Total property}} + \frac{\text{Arizona payroll}}{\text{Total payroll}} + \frac{\text{Arizona sales}}{\text{Total sales}} \times 2$$

4

(4) *Property Factor.*

The Factor. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in Arizona during the tax period, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented when used during the tax period other than real and tangible personal property used by a foreign corporation which is not itself subject to the Arizona corporate income tax or an insurance company exempt from tax under 43-1201. A.R.S. § 43-1140.

Valuation of Property. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals. A.R.S. § 43-1141.

Average Value of Property. The average value of property is determined by averaging the values at the beginning and ending of the tax period, but the Department may require the averaging of monthly values during the tax period if reasonably required to reflect the average value of the tax year's property. A.R.S. § 43-1142.

Safe-Harbor Lease. The property in a safe-harbor leasing transaction, if used in the taxpayer's unitary operations, is included in the property factor of the purchaser/lessor at cost and in the property factor of the seller/lessee at eight times the net annual rate. Department of Revenue Letter to Commerce Clearing House.

(5) *Payroll Factor.*

The Factor. The payroll factor is a fraction, the numerator of which is the total amount paid in Arizona during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period other than compensation paid by a foreign corporation which is not itself subject to the Arizona corporate income tax or an insurance company exempt from tax under 43-1201. A.R.S. § 43-1143.

Compensation Paid In State. Compensation is paid in Arizona if any of the following apply:

- (1) The individual's service is performed entirely within Arizona.

(2) The individual's service is performed both within and without Arizona, but the service performed without Arizona is incidental to the individual service within Arizona.

(3) Some of the service is performed in the state and the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in Arizona.

Deferred Compensation. Earnings included in a qualified cash or deferred arrangement under Section 401(k) of the Internal Revenue Code ("Code") are included in the Arizona payroll factor. Department of Revenue Letter to Commerce Clearing House.

(6) *Sales Factor – Double Weighted.*

The Factor. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in Arizona during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period other than sales of a foreign corporation which is not itself subject to the Arizona corporate income tax or an insurance company exempt from tax under 43-1201. A.R.S. § 43-1145. The sales factor is double weighted. A.R.S. § 43-1139.

Situs of Sales of Tangible Personal Property. Sales of tangible personal property are in Arizona if any of the following apply:

(1) The property is delivered or shipped to a purchaser, other than the United States Government, within Arizona regardless of the FOB² point or other conditions of the sale.

(2) The property is shipped from an office, store, warehouse, factory or other place of storage in Arizona and the purchaser is the United States Government or the taxpayer is not taxable in the state of the purchaser. A.R.S. § 43-1146.

Situs of Sales of Other Than Tangible Personal Property. Sales, other than sales of tangible personal property, are in Arizona if any of the following apply:

(1) the "income-producing activity" is performed in Arizona; or

(2) the "income-producing activity" is performed both in and outside Arizona and a greater proportion of the income-producing activity is performed in Arizona than in any other state, based on costs of performance. A.R.S. § 43-1151. *See Walter E. Heller Western, Inc. v. Arizona Department of Revenue*, 161 Ariz. 49, 775 P.2d 1113 (1989) (taxpayer's business activity was making loans to Arizona businesses; it argued that its securing funds from its out-of-state parent to make the Arizona loans with, was a cost of performance of its "income producing activity" and thus as to a greater proportion of those activities took place outside Arizona. The Arizona Supreme Court concluded that:

we hold that "income producing activity" contemplates direct solicitation, negotiation, and sales activities with consumers in this state.

² "FOB" means "Free On Board" some location (for example, FOB shipping point; FOB destination). The invoice price includes delivery at seller's expense to that location. Title to the goods usually passes from seller to buyer at the FOB location. UCC Section 2-319(1).

This activity includes the solicitation of new customers, the investigation of potential customers' credit records, and the negotiation and servicing of these contracts in Arizona. Though borrowing of funds may be an important step in Heller Western's financing process, the direct generation of the loans occurred in Arizona. We conclude that Heller Western's sales activity in Arizona constituted the income producing activity contemplated by our tax regulations.

This is also the logical conclusion. Heller Western's costs in procuring the money (which is the "product" that it has "sold" to Arizona customers) are analogous to the costs of a merchandise retailer in procuring his inventory. Heller Western can no more argue that its receipts from Arizona loan consumers should not be taxed due to its out-of-state involvement in procuring its "inventory" than a retailer who is engaged in extensive dealings out of state to buy his merchandise could argue that he should not be taxed on the goods he sells to consumers here.

Safe-Harbor Lease. The net rental income derived by the purchaser/lessor from a safe-harbor lease transaction, if otherwise includable, is included in its sales factor, and the interest income derived by the seller/lessee is included in its sales factor. Department of Revenue Letter to Commerce Clearing House.

The Throw-Back Rule – Repealed effective 1/1/98. The test used under A.R.S. § 43-1146 to determine the situs of the sale is the "destination" of the goods. The throw-back rule acts to expand the sales assigned to a particular state by including certain sales that do not meet the "destination" test. Under the throw-back rule, if the corporation is not taxable in the state of destination, the sale is "thrown back" to the state of origin and included in that state's apportionment calculation. The throwback rule attempts to insure that 100% of a multi-state corporation's sales are assigned to a state that has jurisdiction to tax the corporation. Without a throw-back rule, sales made by a multi-state corporation to destinations and states in which it is not subject to tax are not included in the numerator of the sales factor for any state. These sales become, in effect, "nowhere sales." The overall result is that the sum of the apportionment factors for the various states in which the corporation files returns is less than 100%. The theory behind the throw-back rule is that the corporation should be denied the "opportunity of relying on the normal sales attribution rules to produce a tax-free haven for a portion of its income." Hellerstein "Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court reading of the Throw-Back Rule," 45 U. Chi. L. Rev. 768, 770 (1978).

A.R.S. § 43-1146.2 provides the throw-back rule:

sales of tangible personal property are in this state if any of the following apply: . . .

2. The property is shipped from an office, store, warehouse, factory or other place of storage in the state and the purchaser is the United States Government or the taxpayer is not taxable in the state of the purchaser.

The throw-back rule consists of two components. First, the property must be shipped from an office, store, warehouse, factory or other place of storage in Arizona. Second, the purchaser must be the United States Government or the taxpayer is not taxable in the state of destination.

"Sales to the U.S. Government" is a fairly straightforward provision of the throw-back rule but what does "not taxable in the state of destination" mean? This part of the throw-back rule has been the major area of controversy concerning the application of the rule. A.R.S. § 43-1133 provides that a corporation is taxable in another state if:

1. In that state [the taxpayer] is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax.

2. That state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

The provision that the “state has jurisdiction to subject the taxpayer to a net income tax” only means that the state must be able to exercise its power to tax. The state does not actually have to impose a tax upon the multi-state corporation in order for the corporation to be considered taxable in that state for purposes of avoiding the application of the throw-back rule. See *Miles Laboratories Inc. v. Dept. of Rev.*, 546 P.2d 1081 (Oregon 1976). Jurisdiction to tax is not present if the state is precluded from taxing because of Public Law 86-272. See the discussion on this subject in Section 6.

Repeal of Throw Back Rule. The throw back rule was repealed by the 1998 Legislature, specifically by Laws 1998, Fourth Special Session, ch. 3, section 13. The repeal of the throw back rule and the double throw back rule, which is contained in the Department’s regulations, is effective for tax years beginning from and after December 31, 1997.

The Double Throw-Back Rule (also repealed effective January 1, 1998). In addition to the standard throw-back rule, a so-called double throw-back concept is included in the regulatory provisions of the Multi-State Tax Compact and in the Department of Revenue Regulations under UDIPTA. The double throwback rule applies primarily to sales involving the drop shipment of goods--that is, the goods sold are shipped directly by a vendor, from a state in which the taxpayer is not subject to tax, to a customer also located in a state where the taxpayer is not subject to tax. Under the standard throw-back rule, the drop shipment sale would not be included in the state's sales factor because the first component of the throwback rule, “property is shipped from an office, store, warehouse, factory or other place of storage in this state” would not apply. As a result, the drop shipment sale provides a means of circumventing the intent of the standard throw-back rule and of decreasing a corporation's overall sales factor. The double throw-back rule throws the sale first to the vendor's state and if the taxpayer is not taxable there, throws it again to the taxpayer's home state (where sales office is). Regulation R15-2-1146.A.7 establishes the double throw-back rule:

7. If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

a. If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.

b. *If the taxpayer is not taxable in the state from which the third party ships property, then the sale is in this state.* [Emphasis supplied.]

The General Motors Case: No Estoppel Regarding Calculation of Sales Factor. In *General Motors Corp. v. Arizona Dep’t of Revenue*, 189 Ariz. 86, 938 P.2d 481 (App. 1996) (petition for review denied July 1, 1997), the Court of Appeals concluded that the Department of Revenue, which entered into a prior agreement with the taxpayer concerning the calculation of the sales factor of the three factor apportionment formula (for income tax purposes), was not estopped from not following that agreement for future years when there had been an intervening change in regulations. GM was relying on the *Tucson*

Electric Power case but the Court of Appeals disagreed, indicating that choosing the components of the sales factor formula is not a procedural matter, as was involved in the *Tucson Electric Power* case. The Court of Appeals relied upon the *Crane* and *Duham* cases, and Article 9, Section 1 of the Arizona Constitution (the power of taxation shall not be surrendered), to support its no estoppel holding. GM's petition for review to the Arizona Supreme Court was denied.

(7) *Apportionment by Department.*

If the UDIPTA allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in Arizona, the taxpayer may petition for or the Department may require any of the following:

- (1) Separate accounting.
- (2) The exclusion of any one or more of the factors.
- (3) The exclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the state.
- (4) The employment of any other method to effectuate an equitable allocation in apportionment of the taxpayer's income. A.R.S. § 43-1148.

(8) *Apportionment Factors for Special Industries.*

Construction Contractors, Airlines and Railroads. The Model regulations under UDIPTA single out construction contractors, airlines and railroads for special apportionment treatment. However, Arizona has not adopted special apportionment factors for these industries. Such corporations are subject to apportionment and allocation in the same manner as other corporations.

Financial Organizations and Public Utilities. While UDIPTA precludes apportionment and allocation of the income of a financial organization or a public utility, such corporations are subject to the Arizona allocation and apportionment provisions in the same manner as other corporations.

Insurance Companies. Insurance companies are subject to the gross premiums tax rather than the income tax. Thus, the UDIPTA apportionment and allocation mechanism does not apply.

(9) *Apportionment Regulations.*

Department of Revenue Regulations. The Department of Revenue has promulgated regulations interpreting and applying the Uniform Division of Income Tax for Tax Purposes Act. Those regulations are found at R15-2-1131 through 1148.

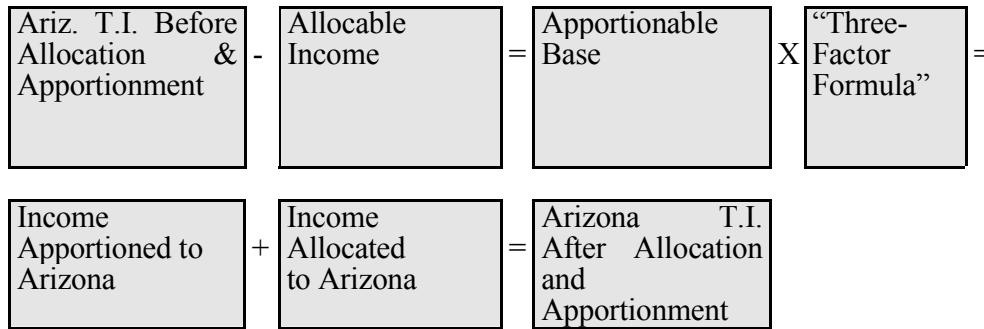
Multi-State Tax Commission Regulations. The MultiState Commission, of which Arizona is an associate but not regular member, has promulgated regulations under UDIPTA. Those regulations are quite detailed and include apportionment factors for special industries, such as construction contractors, airlines, railroads, financial organizations and public utilities.

(10) *Flowchart of Apportionment and Allocation Provisions of UDIPTA.*

Following is a flowchart which shows the apportionment and allocation features of Arizona's version of UDIPTA. You'll note that the apportionment and allocation procedures come into play after Arizona taxable income has been determined. That figure, as seen from Chart No. 1, is a result of making the additions and subtractions to federal taxable income to arrive at Arizona taxable income. Since that figure will include both Arizona and non-Arizona source income, it must be adjusted to "weed out" non-Arizona source income. The UDIPTA apportionment and allocation procedures do just that.

CHART NO. 5

ALLOCATION AND APPORTIONMENT FLOWCHART



Example. Assume that ABC Corp., which is the same corporation as in example no. 1 above, has Arizona taxable income of \$90. Further assume that ABC Corp. has \$10 rental income from real property in Arizona, which is nonbusiness income. Further assume that its apportionment factor (the three-factor formula) is 40%. ABC Corp.'s Arizona taxable income, after apportionment and allocation will be \$42, computed as follows: \$90 minus \$10 (the specifically allocated rental item) equals \$80, times 40% equals \$32, plus \$10 (adding back the rental income specifically allocated to Arizona) equals \$42. The corporate income rate will be applied against that \$42, appropriate tax credits will also be applied, and the result will be Arizona corporate income tax to be paid.

5.8 *Distinction Between Business and Non-Business Income.*

The distinction between business and non-business income is important because business income will be apportioned among all of the states in which the multi-state taxpayer does business in, while non-business income will be allocated to only one state.

The issue usually comes up in a situation where a multi-state taxpayer has income from the sale of property, it could be a plant that is no longer needed, the sale of stock in an affiliated corporation, the sale of a partnership or joint venture interest in a business activity, dividends, royalties, or, perhaps, court awarded damages.

As an example, a business may sell a plant located in a low corporate income rate state or a state that has no corporate income tax at all. If the gain on the sale of the plant were considered non-business income, then it would be allocated in its entirety to the situs state and not apportioned among the several states in which the company does business. If it were considered business income, on the other hand, then it would have to be apportioned and would be subject to tax at the appropriate states' rates, which in this example are higher than the situs states rate (which is a low rate state or no tax state). If the gain were considered to be non-business income, then there would be a potential tax savings. On the other hand, one of the non-situs states may well want to categorize the gain as business income so that it is able to tax its portion of the gain.

Arizona's version of UDIPTA defines "business income" as follows:

"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. A.R.S. § 43-1131.1.

Non-business income is defined to mean "all income other than business income."

The courts have used two tests to differentiate between business and non-business income, the transaction or activity test and the functional test.

Transaction or Activity Test. Did the transaction or activity occur in the regular course of the trade or business of the taxpayer? If it did, then it is business income.

Functional Test. Was the income producing property integrated into the business operations? If it was, then income giving rise from the disposition of that property will be business income.

To best illustrate the difference between the two tests, assume that a taxpayer sells one of its manufacturing plants. This is the first time that the taxpayer has sold any of its operational property. It does not regularly engage in these types of transactions at all. However, the plant is an integral and functional part of its business operations. Under these facts, the transactional test would not be met and the gain on the sale of the plant would be considered to be non-business income. On the other hand, the application of the functional test would characterize the income as business income, since the plant was an integral and functional part of the company's operations, even though the company did not regularly engage in those types of transactions.

The following are some recent business – non-business income cases.

1. *Texaco-Cities Service Pipeline Co. v. Ill. Dept. of Rev.*, 695 N.E.2d 481 (Ill. 1998). Texaco sold a pipeline located in Illinois to a third party. The pipeline was a part of Texaco's operations, which it used to transport oil and other petroleum products it produced. The court concluded that the gain from the sale of the pipeline was business income. The court by necessity had to apply the functional test, because Texaco did not regularly engage in the sale of pipelines. (Illinois Supreme Court).

2. *Ex Parte Uniroyal Tire Co.*, 779 So. 2d 227 (Ala. Aug. 4 2000). Uniroyal entered into a joint venture to which it contributed assets and took a partnership interest. The partnership engaged in the manufacture of tires. Uniroyal later sold its partnership interest to Michelin. Uniroyal took the position that the gain from the sale of its partnership interest should be allocated to its state of domicile, which was Connecticut, rather than apportioned to Alabama. In an administrative hearing, the administrative law judge characterized the gain as non-business income using the transactional test. However, the Alabama Circuit Court applied both the transactional and functional tests and found that Uniroyal's gain was business income and should be apportioned to Alabama.

The Alabama Supreme Court, though, reversed the Court of Appeals, holding that Alabama's definition of business income contains only the transactional test. The Court

concluded that the second clause of the UDIPTA definition of “business income,” which the appeals court concluded established an independent functional test (the “acquisition, management and disposition of the property”), uses the conjunction “and” rather than “or.” The Court held that the words “and” and “or” are not interchangeable and their use should be followed unless the construction makes the statute inoperable or the meaning becomes questionable. The Alabama Supreme Court found that by interpreting the word “and” to also mean “or” could “eclipse entirely the transactional test.” The Court distinguished the *Polaroid* case, which held that the North Carolina definition of “business income” embodied an independent, functional test, on the basis that North Carolina’s definition of “business income,” and specifically the second part dealing with the “acquisition, management, and disposition of the property” used the words “and/or” rather than the conjunction “and” as the Alabama definition did.

It should be noted that Arizona’s definition of business income uses the conjunction “and” and not “or,” or “and/or.” Thus, the *Uniroyal* decision should have considerable bearing on Arizona’s definition. In fact, it could be argued that following *Uniroyal*, Arizona’s definition of business income embodies only a transactional test and not an independent functional test.

3. *Polaroid Corp. v. Offerman*, 507 S.E.2d 284 (N.C. 1998) *cert denied*, 119 S. Ct. 1576 (1999). Polaroid sued Kodak for patent infringement and recovered some \$900 million which was composed of some \$233 million of damages for “lost profits”, an additional \$204 million for “loss profits” determined on the basis of a “reasonable royalty” and prejudgment interest in the amount \$435 million. Polaroid took the position that the court awarded damages was non-business income, since it was not regularly engaged in suing others and recovering damages. The North Carolina Court of Appeals agreed with Polaroid. However, the North Carolina Supreme Court reversed, concluding that the court awarded damages was business income. Again, by necessity, the North Carolina Supreme Court had to use, and did use, the functional test, since the application of the transactional test, by itself, would result in the damages being characterized as non-business income. The court determined that both the lost profits, the lost profits determined on the basis of a “reasonable royalty”, and prejudgment interest were all business income, that given Polaroid’s recovery constituted income in lieu of profits, that income should be classified as business income because it represents the disposition of assets integral to Polaroid’s regular trade or business operations. The court also observed that “the judgment partly represents profits which Polaroid would have earned absent Kodak’s infringement. Those profits would have properly been considered apportionable income had they been earned in the normal manner. The fact that they were received in the court room instead of the marketplace is irrelevant. Moreover, the monies received from the Kodak lawsuit were used as part of Polaroid’s working capital and therefore constitute part of Polaroid’s unitary business”. 1998 N.C. LEXIS 727 at p. 20.

Another issue involved in the *Polaroid* case, was whether the definition of “business income” found in UDIPTA included the functional test, or whether it was just a transactional test. The court concluded that the following italicized portion of the definition embodied the “functional test”:

“Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business. *And includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.*

Polaroid had argued that the italicized portion of the definition was essentially modifying the transactional test, which is the first part of the definition, and did not set forth a second, independent functional test for business income. Polaroid argued that business income arises from transactions or activities in the regular course of the corporation's trade or business and that the phrase "and includes" merely modifies the first clause by providing examples of what fits within the definition.

The *Polaroid* decision is noteworthy because it concludes that UDIPTAs' definition of business income embodies both the transactional and the functional test, with income being characterized as business income if either of the tests is met.

4. *Hoechst Celanese v. Franchise Tax Board*, 25 Cal.4th 508, 527, 22 P.3d 324, 337 (Ca. 2001). In the *Hoechst Celanese* case, the California Supreme Court took the position that the California definition of "business income" contains both a transactional test and a separate functional test. 25 Cal.4th at 526, 22 P.3d at 336. The court took this position, in part, "in the interests of promoting uniformity" among states that have adopted UDITPA. *Id.* The court included an extensive discussion of the North Carolina Supreme Court's decision in *Polaroid Corp. v. Offerman*, 507 S.E.2d 284 (1998) in support of the position that the UDITPA definition could be interpreted as creating both a transactional and functional test. 25 Cal.4th at 521, 22 P.3d at 333.

In construing the phrase, "acquisition, management, and disposition of the property," the California supreme court rejected the Board's argument that "and" should be given a disjunctive meaning because "'and' is ordinarily conjunctive and because nothing suggests a legislative intent to give 'and' a different meaning." 25 Cal.4th at 528, 22 P.3d at 338.

After a lengthy discussion of each term in the second phrase of the UDITPA definition, the court concluded that "income is business income under the functional test if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations." 25 Cal.4th at 532, 22 P.3d at 340.

The court then noted that its interpretation of California's business income test is consistent with prior California Court of Appeals decisions, and cited favorably, among other cases, *Robert Half International, Inc. v. FTB*, No. A079671 (Ca. Court of Appeals, Sept. 21, 1988). 25 Cal.4th at 532-33, 22 P.3d at 340-41.

5. *Lenox v. Tolson*, 353 N.C. 659; 548 S.E.2d 513 (N.C. 2001). The *Lenox* case involved a conglomerate New Jersey-based corporation, Lenox, with multistate operating divisions engaged in the business of manufacturing and selling numerous consumer products. In 1970, Lenox established its ArtCarved division to manufacture and sell fine jewelry. In 1988, because ArtCarved had not been profitable, Lenox sold all of the assets of its ArtCarved division pursuant to a restructuring plan and seceded from the fine jewelry manufacturing business. Lenox classified the gain as "nonbusiness income" on its North Carolina tax return and did not pay taxes on the gain. The North Carolina Department of Revenue, however, reclassified the gain as business income and assessed corporate income tax, which Lenox paid under protest. Lenox then filed a refund action to recover this amount. The trial court granted the department's summary judgment motion.

On appeal, the North Carolina Court of Appeals reversed the trial court's judgment, stating that, even under that state's broader definition of "business income," when the sale of an asset represents a partial liquidation, the court must "focus on more than whether or not the asset is integral to the corporation's business." *Lenox v. Offerman*, 538

S.E.2d 203 (N.C. Ct. App. 2000). In its opinion, the North Carolina Court of Appeals cited an earlier North Carolina Supreme Court case, *Polaroid Corp. v. Offerman*, 507 S.E.2d 284 (1998), but declined to follow the higher court's lead in applying a "straightforward application of the functional test." *Lenox*, 538 S.E.2d at 205, 207-208. Accordingly, the Department of Revenue appealed the case to the North Carolina Supreme Court.

In taking up the *Lenox* appeal, the North Carolina Supreme Court disavowed its earlier conclusions that the extraordinary nature or infrequency of the transaction is irrelevant and that income from the acquisition, management, and/or disposition of an asset that was integral to a taxpayer's regular trade or business constitutes business income regardless of how the income is received. *Lenox*, 548 S.E.2d at 517. In *Lenox*, the court stated "[t]he wording of these two sentences in *Polaroid* is a cause of confusion, and we hereby disavow these statements." The court went on to explain:

The statements in *Polaroid* are in direct contravention of the functional test of our statute which requires that the 'property constitute [an] integral part[] of the corporation's *regular* trade or business operations.' The source of corporate income cannot be disregarded, as extraordinary or infrequent transactions may well fall outside a corporation's regular trade or business. Again, the focus must be on the asset or property that generated the income and its relationship to the corporation's regular trade or business. To use such overly broad language as we have just disavowed would render the statutory definition of 'nonbusiness income' meaningless.

548 S.E.2d at 517. (Emphasis in original).

The court further stated that "when an asset is sold pursuant to a complete or partial liquidation, the court must focus on more than the question of whether the asset was integral to the corporation's business. Partial or complete liquidations are extraordinary events and are not recurring transactions." *Id.* With regard to *Lenox's* disposition of its ArtCarved division, the court held that the sale "did not generate business income because the liquidation of this asset was not an integral part of *Lenox's* regular trade or business." *Id.* at 520.

6. NEXUS AND PUBLIC LAW 86-272.

6.1 Public Law 86-272.

Jurisdiction to tax is not present where a state is prohibited from imposing its tax because the corporation's activities do not exceed the standard of mere solicitation of sales established by Public Law 86-272. Public Law 86-272 provides in pertinent part:

No state, or political subdivision thereof, shall have power to impose, . . . a net income tax on the income derived within such state by any person from intrastate commerce if the only business activities within such state by or on behalf of such a person during the taxable year are . . . :

1. The solicitation of orders by such person, or his representative, in such state for sales of tangible personal property, which orders are sent outside the state for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside of the state; . . .

States are thus prevented under Public Law 86-272 from taxing out-of-state corporations on income derived from business activities within the state if their activities are limited to "mere solicitation of orders" for the sale of tangible personal property and the orders are approved and filled from outside the state. If the standard of mere solicitation of orders is

not exceeded in a destination state, the throw-back rule will apply to such sales. On the other hand, if the standard is exceeded, the sales would not be subject to the throw-back rule.

The member states of the multi-state tax commission have promulgated guidelines with respect to the application of P.L. 86-272. Arizona adopted (and modified) these guidelines as a part of Arizona Corporate Tax Ruling CTR 99-5 (which superseded CTR 95-2). The salient points of CTR 99-5 follow:

* * *

The following information reflects the Arizona Department of Revenue's current practices with regard to (1) whether a particular factual circumstance is considered under P.L. 86-272 or permitted under this ruling as either protected or not protected from taxation by reason of P.L. 86-272; and (2) the jurisdictional standards which will apply to sales made in another state for purposes of applying a throwback rule (if applicable) with respect to such sales. It is the intent of the department to apply this ruling uniformly to factual circumstances irrespective of whether such application involves an analysis for jurisdictional purposes in the state into which such tangible personal property has been shipped or delivered or for throwback purposes in the state from which such property has been shipped or delivered.

I

Nature of Property Being Sold

Only the solicitation to sell personal property is afforded immunity under P.L. 86-272; therefore, the leasing, renting, licensing or other disposition of tangible personal property, or transactions involving intangibles, such as franchises, patents, copyrights, trademarks, service marks, and the like, or any other type of property are not protected activities under P.L. 86-272.

The sale or delivery and the solicitation for the sale or delivery of any type of service is not either (1) ancillary to solicitation or (2) otherwise set forth as a protected activity under the Section IV.B. hereof is also not protected under P.L. 86-272 or this ruling.

II

Solicitation of Orders and Activity Ancillary to Solicitation

For the in-state activity to be protected activity under P.L. 86-272, it must be limited solely to *solicitation* (except for *de minimis* activities described in Article III and those activities conducted by independent contractors described in Article V, below). Solicitation means (1) speech or conduct that explicitly or implicitly invites an order; and, (2) activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order.

Ancillary activities are those activities that serve no independent business function for the seller apart from their connection to the solicitation of orders. Activities that a seller would engage in apart from soliciting orders shall not be considered as ancillary to the solicitation of orders. The mere assignment of activities to sales personnel does not, merely by such assignment, make such activities ancillary to solicitation of orders. Additionally, activities that seek to promote sales are not ancillary because P.L. 86-272 does

not protect activity that facilitates sales, it only protects ancillary activities that facilitate the request for an order. The conducting of activities not falling within the foregoing definition of solicitation will cause the company to lose its protection from a net income tax afforded by P.L. 86-272, unless the disqualifying activities, taken together, are either *de minimis* or are otherwise permitted by this ruling.

III

De Minimis Activities

De minimis activities are those that, when taken together, establish only a trivial connection with the taxing state. An activity conducted within a taxing state on a regular or systematic basis or pursuant to a company policy (whether such policy is in writing or not) shall normally not be considered trivial. Whether or not an activity consists of a trivial or non-trivial connection with the state is to be measured on both a qualitative and quantitative basis. If such activity either qualitatively or quantitatively creates a non-trivial connection with the taxing state, then such activity exceeds the protection of P.L. 86-272. Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing state is not determinative of whether a *de minimis* level of activity exists. The relative economic importance of the disqualifying in-state activities, as compared to the protected activities, does not determine whether the conduct of the disqualifying activities within the taxing state is inconsistent with the limited protection afforded by P.L. 86-272.

IV

Specific Listing of Unprotected and Protected Activities

The following two listings (IV.A and IV.B) set forth the in-state activities that are presently treated by the state of Arizona as “Unprotected Activities” or “Protected Activities.”

The state has included on the list of “Protected Activities” those in-state activities that are either required protection under P.L. 86-272, or, if not so required, that the state, in its discretion, has permitted protection. The mere inclusion of an activity on the listing of “Protected Activities,” therefore, is not a ruling or admission by the state that said activity is required any protection under the Public Law.

A. Unprotected Activities:

The following in-state activities (assuming they are not of a *de minimis* level) are not considered as either solicitation of orders or ancillary thereto or otherwise protected under P.L. 86-272 and will cause otherwise protected sales to lose their protection under the Public Law.

1. Making repairs or providing maintenance or service to the property sold or to be sold.
2. Collection of current or delinquent accounts, whether directly or by third parties, through assignment or otherwise.
3. Investigating credit worthiness.

4. Installation or supervision of installation at or after shipment or delivery.
5. Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation.
6. Providing any kind of technical assistance or service including, but not limited to, engineering assistance or design service, when one of the purposes thereof is other than the facilitation of the solicitation of orders.
7. Investigating, handling, or otherwise assisting in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.
8. Approving or accepting orders.
9. Repossessing property.
10. Securing deposits on sales.
11. Picking up or replacing damaged or returned property.
12. Hiring, training, or supervising personnel, other than personnel involved only in solicitation.
13. Using agency stock checks or any other instrument or process by which sales are made within this state by sales personnel.
14. Maintaining a sample or display room in excess of two weeks (14 days) at any one location within the state during the tax year.
15. Carrying samples for sale, exchange or distribution in any manner for consideration or other value.
16. Owning, leasing, using, or maintaining any of the following facilities or property in-state:
 - a. Repair shop.
 - b. Parts department.
 - c. Any kind of office other than an in-home office as described as permitted under IV.A.18 and IV.B.2.
 - d. Warehouse.
 - e. Meeting place for directors, officers, or employees.
 - f. Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.
 - g. Telephone answering service that is publicly attributed to the company or to employees or agent(s) of the company in their representative status.

h. Mobile stores, *i.e.*, vehicles with drivers who are sales personnel making sales from the vehicles.

i. Real property or fixtures to real property of any kind.

17. Consigning stock of goods or other tangible personal property to any person, unless: (1) The in-state presence of the consignment inventory is a requirement of a contract with an in-state customer; and (2) The consignment inventory is located on the in-state customer's property.

18. Maintaining by any employee or other representative, an office or place of business of any kind (other than an in-home office located within the residence of the employee or representative that (i) is not publicly attributed to the company or to the employee or representative of the company in an employee or representative capacity, and (ii) so long as the use of such office is limited to soliciting and receiving orders from customers, for transmitting such orders outside the state for acceptance or rejection by the company, or for such other activities that are protected under P.L. 86-272 or under paragraph IV.B of this ruling).

A telephone listing or other public listing within the state for the company or for an employee or representative of the company in such capacity or other indications through advertising or business literature that the company or its employee or representative can be contacted at a specific address within the state shall normally be determined as the company maintaining within this state an office or place of business attributable to the company or to its employee or representative in a representative capacity. However, the normal distribution and use of business cards and stationery identifying the employee's or representative's name, address, telephone and fax numbers, and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.

The maintenance of any office or other place of business in this state that does not strictly qualify as an "in-home" office as described above shall, by itself, cause the loss of protection under this ruling. For the purpose of this subsection it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining such in-home office.

19. Entering into franchising or licensing agreements, selling or otherwise disposing of franchises and licenses, or selling or otherwise transferring tangible personal property pursuant to such franchise or license by the franchiser or licensor to its franchisee or licensee within the state.

20. Conducting any activity not listed in paragraph IV.B. below which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

B. Protected Activities:

The following in-state activities will not cause the loss of protection for otherwise protected sales:

1. Soliciting orders for sales by any type of advertising.

2. Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or

other place of business in the state other than an “in-home” office as described in IV.A.18. above.

3. Carrying samples and promotional materials only for display or distribution without charge or other consideration.

4. Furnishing or setting up display racks and advising customers on the display of the company's products without charge or other consideration.

5. Providing automobiles to sales personnel for their use in conducting protected activities.

6. Passing orders, inquiries, and complaints on to the home office.

7. Missionary sales activities; i.e., the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of retailers to buy the manufacturer's goods from the manufacturer's wholesale customers would be protected if such solicitation activities are otherwise immune.

8. Coordinating shipment or delivery without payment or other consideration and providing information relating thereto either prior or subsequent to the placement of an order.

9. Checking of customers' inventories without a charge therefor (for re-order, but not from other purposes such as quality control).

10. Maintaining a sample or display room for two weeks (14 days) or less at any one location within the state during the tax year.

11. Recruiting, training, or evaluating sales personnel, including occasionally using homes, hotels, or similar places for meetings with sales personnel.

12. Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

13. Owning, leasing, using, or maintaining personal property for use in the employee's or representative's “in-home” office or automobile that is solely limited to the conducting of protected activities. Therefore, the use of personal property such as a cellular telephone, facsimile machine, duplicating equipment, personal computer, and computer software that is limited to the carrying on of protected solicitation and activity entirely ancillary to such solicitation or permitted by this ruling under paragraph IV.B. shall not, by itself, remove the protection under this ruling.

14. Shipping or delivery goods into this state by means of common carrier, contract carrier, private vehicle, or by any other method or carrier, irrespective of whether a shipment or delivery free or other charge is imposed, directly or indirectly, upon the purchaser.

15. Consigning inventory to an in-state customer if: (1) The in-state presence of the consignment inventory is a requirement of a contract with the in-state customer; and (2) The consignment inventory is located on the in-state.

V

Independent Contractors

P.L. 86-272 provides protection to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the company or its employees or other representatives. Independent contractors may engage in the following limited activities in the state without the company's loss of immunity:

1. Soliciting sales.
2. Making sales.
3. Maintaining an office.

Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as those provided under P.L. 86-272 and this ruling.

Maintenance of a stock of goods in the state by the independent contractor under consignment or any other type of arrangement with the company except for purposes of display and solicitation is not a protected activity.

VI

Application of Destination State Law in Case of Conflict

When it appears that two or more sales have included or will include the same receipts from a sale in their respective sales factor numerators, this state may review what law, regulation, or written guideline, if any, has been adopted in the state of destination with respect to the issue. The state of destination shall be that location at which the purchaser or its designee actually receives the property, regardless of f.o.b. point or other condition of sale.

In determining which state is to receive the assignment of the receipts at issue, preference shall be given to any clearly applicable law, regulation, or written guideline that has been adopted in the state of destination. However, except in the case of the definition of what constitutes "tangible personal property," this state is not required by this ruling to follow any other state's law, regulation, or written guideline should this state determine that to do so (i) would conflict with its own laws, regulations, or written guidelines, and (ii) would not clearly reflect the income-producing activity of the company within this state.

Notwithstanding any provision set forth in this ruling to the contrary, as between this state and any other state, this state will apply the definition of "tangible personal property" that exists in the state of destination to determine the application of P.L. 86-272 and issues of throwback, if any. Should the state of destination not have any applicable definition of such term then this state shall treat such property in a manner that will clearly reflect the income-producing activity of the company within this state.

VII

Miscellaneous Practices

A. Application of Statement Ruling to Foreign Commerce

P.L. 86-272 specifically applies, by its terms, to “interstate commerce” and does not directly apply to foreign commerce. The state may, however, apply the same standards set forth in the Public Law and in this ruling to business activities in foreign commerce to ensure that foreign and interstate commerce are treated on the same basis. Such an application also avoids the necessity of expensive and difficult efforts in the identification and application of the varied jurisdictional laws and rules existing in foreign countries.

This state will apply the provisions of P.L. 86-272 and of this ruling to business activities conducted in foreign commerce. Therefore, whether business activities are conducted by (i) a foreign or domestic company selling tangible personal property into a country outside of the United States from a point within this state, or by (ii) either company selling such property into this state from a point outside of the United States, the principles under this ruling apply equally to determine whether the sales transactions are protected and the company immune from taxation in either this state or in the foreign country, as the case may be, and whether, if applicable, this state will apply its throwback provisions.

B. Application to Corporation Incorporated in State or to Person Resident or Domiciled in State

The protection afforded by P.L. 86-272 and the provisions of this ruling do not apply to any corporation incorporated within this state or to any person who is a resident of or domiciled in this state.

C. Registration or Qualification to Do Business

A company that registers or otherwise formally qualifies to do business within this state does not, by that fact alone, lose its protection under P.L. 86-272. Where, separate from or ancillary to such registration or qualification, the company receives and seeks to use or protect any additional benefit or protection from this state through activity not otherwise protected under P.L. 86-272 or this ruling, such protection shall be removed.

D. Loss of Protection for Conducting Unprotected Activity During Part of Tax Year

The protection afforded under P.L. 86-272 and the provisions of this ruling shall be determined on a tax year by tax year basis. Therefore, if at any time during a tax year the company conducts activities that are not protected under P.L. 86-272 or this ruling, no sales in this state or income earned by the company attributed to this state during any part of said tax year shall be protected from taxation under said Public Law or this ruling.

E. Application of the Finnigan/Airborne Navigation Rule

Pursuant to the principle reported in *Airborne Navigating Corporation v. Arizona Department of Revenue*, Feb. 5, 1987, CCH Ariz. Tax Reports, Paragraph 200-744, when a group of companies is conducting a unitary business and a part of that unitary business is conducted within this state, the activities of all members of the unitary group will be included in both the numerator and denominator of the sales factor.

6.2 The Wrigley Case.

The U.S. Supreme Court addressed for the first time the solicitation limitations of P.L. 86-272 in *Wisconsin Department of Revenue v William Wrigley, Jr.*, 505 U.S. 214, 112 S.Ct. 2447 (1992). The Supreme Court's decision addressed two points. (1) what is the scope of protected solicitation; and (2) a *de minimis* exception.

(1) *What is Protected Solicitation?*

The extent of the protection afforded by P.L. 86-272 depends largely on the interpretation of the phrase "solicitation of orders," which the statute does not define.

The Supreme Court began its analysis by referring to the dictionary definition of "solicitation." It found that the term includes not only explicit verbal requests for orders, but also "any speech or conduct that implicitly invites an order." The Court saw the key question to be "whether, and to what extent, 'solicitation of orders' covers activities that neither explicitly nor implicitly propose a sale".

The Court rejected Wisconsin's argument that "solicitation of orders" should be construed narrowly, covering only the ultimate act of inviting an order. This limited definition would render P.L. 86-272 meaningless. Moreover, the Court noted, "this extremely narrow interpretation of 'solicitation' would cause § 381 to leave virtually unchanged the law that existed before its enactment." Under the definition of solicitation proffered by Wisconsin, the decisions in *Brown-Forman* and *International Shoe* would, today, remain unchanged--not the result that Congress intended when it enacted P.L. 86-272.

The Court also rejected Wrigley's interpretation of solicitation: any activities that were "ordinary and necessary 'business activities' accompanying the solicitation process" or were "routinely associated with deploying a sales force to conduct the solicitation. . . ." Wrigley's routinely-associated-with standard was overly broad because it looked beyond a particular activity (solicitation) to all activities routinely carried on by those who engage in that particular activity (salesmen). The Court also concluded that Wrigley's approach was unworkable because it permitted solicitation to be whatever a particular industry wanted. This would render P.L. 86-272 "toothless."

The Court concluded that only "those activities that are *entirely ancillary* [emphasis in original] to requests for purchases--those that serve no independent business function apart from their connection to the soliciting of orders" (as opposed to "those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force") fall within the immunity afforded by P.L. 86-272. The Court stated that, for example, providing a car and a stock of free samples to salesmen is part of the solicitation process; employing salesmen to repair or service the company's products is not.

(2) *De Minimis Rule.*

The Court declined to conclude that, as Wisconsin suggested, all post-sale activities were necessarily beyond the scope of solicitation of orders. Although activities that take place after a sale ordinarily are not "entirely ancillary" to requests for purchases, the Court was not prepared to say this was always true. Moreover, the Court found the pre-sale/post-sale distinction to be unworkable. Manufacturers and distributors ordinarily have ongoing relationships with their customers that involve continuous sales, making it difficult to determine whether a particular activity was related to the sale that preceded or followed it.

The Wisconsin Supreme Court had applied a *de minimis* standard, holding that a company does not necessarily forfeit immunity under P.L. 86-272 merely because it performed some in-state activities that exceeded solicitation. The U.S. Supreme Court

agreed. Under the standard articulated by the Court, however, activities not ancillary to requesting purchases will subject a foreign seller to tax only if the activity creates “a nontrivial additional connection with the taxing State.”

(3) *Specific Activities Addressed.*

In applying its newly established guidelines to Wrigley, the Court focused its attention on six specific activities engaged in by Wrigley’s Wisconsin representatives:

Not protected:

1. Replacing stale gum.
2. Supplying gum through agency stock checks.
3. Storing gum, display racks, and promotional materials.
4. Renting storage space.

Protected:

5. Recruiting, training, and evaluating employees.
6. Intervening in credit disputes.
7. In state sales meetings.

The Court found that replacing stale gum, supplying gum through agency stock checks, storing gum, and renting storage space were not ancillary to requests for purchases. In the Court's view, these activities served an independent business purpose separate and apart from requesting orders. On the other hand, the Court concluded that in-state recruitment, training, and evaluation of employees, intervention in credit disputes, and the use of in-state locations for sales meetings served no purpose other than to facilitate solicitation.

Since the Court concluded that Wrigley had engaged in activities that were not ancillary to requesting orders, the Court considered whether its *de minimis* exception applied. The Court concluded that the activities in question were not *de minimis*. The Court noted that Wrigley's sales representatives engaged in non-immune activities on a continuing basis as a matter of company policy.

6.3 *P.L. 86-272 – Cases.*

Kelly-Springfield Tire Co. v. Bajorski, 635A. 2d 771 (Conn. 1993). Multistate corporations that sold motor vehicle and truck tires to dealers throughout the United States was immune from the Connecticut corporation business tax under the federal Interstate Income Law, P.L. 86-272 (15 U.S.C. Sec. 381), because its Connecticut activities were *de minimis*. The taxpayer had registered to transact business in Connecticut, but did not maintain any inventory nor owned any real property in the state. The taxpayer’s Connecticut business operations were carried out through the services of one or more local sales representatives whose sole authority was the solicitation of orders from tire dealers. The taxpayer’s only other operational presence consisted of annual visits by its credit manager to the taxpayers’ accounts in the state. The Commissioner of Revenue failed to establish that the taxpayer’s activities in the state were more than *de minimis* so that they were not within the terms of P.L. 86-272 and, therefore, the state was precluded from imposing a corporation business tax on the intrastate activities of the taxpayer.

Amgen Inc. v. Mass. Com'r. of Rev., 427 Mass. 357, 693 N.E. 2d 175, 1998 Mass. LEXIS 179 (April 23, 1998). Drug company's sales force exceeded "solicitation of orders" by reviewing patient charts and answering questions about use and dosage of company's products for specific patients.

Kennametal Inc. v. Mass. Com'r. of Rev., 118 S. Ct. 1386, 1998 U.S. LEXIS 2319, 140 L. Ed. 2d 646; petition for writ of certiorari denied, 426 Mass. 39, 686 N.E. 2d 163 (April 6, 1998). Sales force exceeded "solicitation of orders" by providing technical information to customers and assisting customers in determining what product to order.

National Private Truck Council v. Com'r. of Rev., 426 Mass. 324, 688 N.E. 2d 936 (1997). Massachusetts regulation which limited immunity only to delivery by common carrier, and not taxpayer's own trucks, was invalid.

National Private Truck Council v. Virginia, 253 Va. 74, 1997 Va. LEXIS 12, 480 S.E. 2d 500 (January 10, 1997). The same result was reached by The Virginia Supreme Court in this case as in the Massachusetts.

The Upjohn Company, et al. v. State of Arizona Department of Revenue, Tax Court, TX-1997-0000438 (October 18, 2001), the court held that: Public Law 86-272 does not protect Upjohn from Arizona corporate income taxation because its activities exceeded protected "solicitation of sales." The Court observed that Public Law 86-272 in short precludes a state from imposing its income tax on an out of state business whose only activities in the state are "solicitation of sales." The Department argued that three types of Upjohn's conduct went beyond the mere solicitation of sales, thereby subjecting Upjohn to state income tax. The Department argued that Upjohn tested drugs in Arizona before they were marketed. However, the court found that Upjohn did not conduct testing in Arizona. Upjohn's sales representatives, in addition to soliciting sales, provided customers with product information and treatment suggestions, checked the customers' stock and informed them when stock had expired, provided customers with forms to exchange the expired stock and forwarded customers' complaints to the home office. In emergency situations, sales representatives transferred products between hospitals. The court concluded that the sales representatives' activities facilitated the "requesting of sales" and served no independent business function apart from the solicitation of orders. Thus, this activity did not go beyond the protected activity of "solicitation of sales." The education MSLS consulted with people in the medical education field and suggested ways to train and assist physicians in diagnosis, treatment and care. The science MSLS exchanged information about medical developments, discussing basic medical research that needed to be done in potential studies with medical leaders in that area to develop new products. The court concluded that these activities have an independent business purpose other than the solicitation of sales in that the activities of the MSLS facilitate research and product development. The court thus concluded that the activities were not ancillary to the solicitation of sales, nor were they performed by sales representatives. The court further concluded that the activities of the MSLS were significant and, therefore, do not qualify as de minimis contacts with the state (which will not result in taxation), thereby subjecting Upjohn to Arizona income tax.

7. THE “UNITARY CONCEPT” AND COMBINED REPORTING.

7.1 Background.

In order to properly apply formula apportionment, the business operations of the corporation must be unitary. If the in-state business operation of the corporation (*i.e.*, a division) is not engaged in a unitary business with the out-of-state divisions of the corporation, then formula apportionment cannot be used to determine the corporation's Arizona source income. Rather, separate accounting would be used. The Supreme Court has referred to the unitary business concept as the “linchpin of apportionability.” *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980). This phrase, which is the keystone of formula apportionment, means that a state cannot use an apportionment formula to divide the income of a business enterprise unless all the income included in the apportionable base is derived from business activities “unitary” with the business carried on in the taxing state.

7.2 Definition of Unitary Business.

A unitary business may be comprised of branches or divisions of a single corporation or of commonly controlled but separate corporations. The criteria usually applied for determining if the operations of a business are unitary include: the percentage of one corporation's common stock owned by another; the sharing of centralized services, such as accounting and advertising; and the type and number of transactions carried between corporate entities. However, no universally agreed-upon criteria exist. GAO Report page 4.

7.3 Classic Example of Unitary Business.

A classic example of a “unitary” business is a railroad company that owns and operates a national network of railroad lines. The Courts have been willing to view such a railroad business as “unitary” because it operates as an “organic whole.” See, *e.g.*, *Nashville C. & St. Louis Ry. v. Browning*, 310 U.S. 362 (1940); *Norfolk and Western Ry. Co. v. N. Carolina*, 297 U.S. 682 (1936). Because the value of the national rail network enhances the value of the in-state rail network, the income from the entire national business may be included in the apportionable base.

7.4 Expansion of Unitary Concept to Multi-Corporate Entities.

Originally, the states applied formula apportionment only when the unitary business was a single corporation. For example, a single corporation might encompass administrative offices in a manufacturing plant located in one state with a second plant in another state. To determine how much of the corporation's income was attributable to each state, each of the two states would apply its apportionment formula to the single corporation's entire operation. GAO Report page 4.

In time, the states expanded their definition of a unitary business. These states, most notably California, decided that a unitary business could consist not only of one corporation but of a group of affiliated corporations doing business in several states. As a result, the states began taxing multi-corporate entities in the same manner as single corporations. A state's application of its apportionment formula became dependent upon its determination that a business entity was unitary and not upon a particular corporate structure. For example, a group of separate corporations performing different functions (for example, manufacturing, distributing, selling) in different states but engaged in the same unitary business were treated the same as a single corporation with several divisions conducting business operations in several states. Applying the unitary concept in its broader

context, a state would apply its apportionment formula to the combined income of the affiliated group of corporations that made up the unitary business. GAO Report pages 4 and 5.

7.5 *Method of Implementing the Unitary Concept--The Combined Report.*

The Combined Report is an approach for determining the income attributable to a particular state of each corporate member of an affiliated group conducting a unitary business both within and without the taxing state. The determination of the proportionate amount of the unitary income attributable to the activities of the corporation or corporations doing business in the taxing state is generally accomplished by first combining the net income of each of the affiliated corporations and then applying to this base a combined apportionment ratio. The ratio is comprised of the respective total in-state factors of the entire group divided by its total everywhere factors. Related intercompany transactions and transfers are generally eliminated from both the apportionable income base and apportionment formula because they do not usually increase the wealth or profitability of the business but represent a shuffling among affiliated companies of receipts previously generated and accounted for by the individual "units" of the business. If there is more than one member of the affiliated group doing business in the taxing state, the portion of the unitary income assigned to the state must also be apportioned among those members subject to the state's taxing jurisdiction. In practice, this additional step is omitted in many cases and the entire tax is assessed on the return of only one member (the "key corporation") of the unitary group. Combined Reporting "The Approach And Its Problems," Journal of State Taxation, Volume 1, No. 1, Page 5, Spring 1982.

7.6 *Combined Report v. Consolidated Return - Distinguished.*

Consolidated Return. Although the terms are often used interchangeably, a combined report is not the same as a consolidated return. Generally, the total income of the corporations within a consolidated group is reported on a single return and a single tax is paid thereon for which each member of the group is jointly and severally liable. The consolidated income subject to tax is not limited to an amount related to a specific unitary business.³ Since states may not ordinarily tax income from sources outside the state or subject corporations not present in the state to tax, a consolidated return generally applies to affiliated corporations subject to the jurisdiction of the taxing state.

Combined Report. In a combined report, on the other hand, the combined income of the affiliated group is not computed for the purpose of taxing such income, but rather as a basis for determining the portion of income from the entire unitary business attributable to sources within the state which is derived by members of the group subject to the state's jurisdiction. Again, it is viewed as more of an informational return than a tax return. Combined Reporting: "The Approach End of Problems," Journal of State Taxation, Vol. 1, No. 1, Page 5, Spring 1982.

7.7 *Basis of the Combined Report--Extent of Application of the Unitary Concept.*

³ If the group is engaged in an interstate business it is necessary to apply an appropriate apportionment formula to determine the part of the consolidated income taxable by a particular state.

The states either permit or require a variety of types of combined reports all depending upon the extent to which the states apply the unitary concept. There are three general bases for applying the unitary concept:

(1) *Unitary Business Theory Applied on a Separate Entity Basis.*

When the unitary business theory is applied on a "separate entity" basis, the state imposes tax on its apportioned share of all net income derived by the taxpayer-corporation from the corporation's unitary business, part of which is carried on within the state. This was the approach used by the taxing authorities in the following Supreme Court decisions: *F. W. Woolworth v. Taxation and Revenue Department of the State of New Mexico*, 458 U.S. 354, 102 S. Ct. 3128, 73 L. Ed. 2d 819 (1982); *ASARCO v. Idaho State Tax Commission*, 458 U.S. 307, 102 S. Ct. 3103, 73 L. Ed. 2d 787 (1982); *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 100 S. Ct. 2109 (1980); and *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S. Ct. 1223 (1980). This use of the unitary business theory is referred to as "separate entity reporting."

(2) *Unitary Business Theory Applied on a Domestic Combined Reporting Basis.*

In this application of the unitary business theory, the state imposes tax on its apportioned share of all net income derived by the taxpayer-corporation *and its U.S. affiliates* from a unitary business, part of which is carried on within the state. The state, in other words, seizes upon the presence in the state of one corporate entity that is a member of a group of affiliated corporations, and asserts that the combined net incomes of all U.S. corporations in the affiliated group are includable in the in-state corporation's apportionable base. This use of the unitary business theory is referred to as "domestic combined reporting" or "domestic combination."

Essential to a state's assertion of the unitary theory on a domestic combined basis is that the corporations included in the combined report be engaged in a business that is unitary with the business carried on by the in-state member of the affiliated group. The due process clause of the U.S. Constitution requires that income from related corporations--or even from separate divisions within a single corporate entity-- be included in the apportionable base of the in-state taxpayer only if the income is from sources that are unitary with the business the taxpayer carries on within the taxing state. *ASARCO v. Idaho State Tax Commission*, 102 S. Ct. at 3112; and *F. W. Woolworth v. Taxation and Revenue Department of the State of New Mexico*, 102 S. Ct. at 3139.

(3) *Unitary Business Theory Applied on a Worldwide Combined Reporting Basis.*

In this expanded application of the unitary business theory, the state imposes tax on its apportioned share of all net income derived by the taxpayer-corporation *and its affiliates worldwide* from a unitary business, part of which is carried on within the state. The distinction between worldwide and domestic combination is that states employing domestic combination adopt a "water's edge" approach to determining what corporations will be included in the combined group to arrive at the apportionable base. If the unitary business theory is applied on a worldwide combined reporting basis, the net incomes of all corporations unitary with the in-state corporation are included in that corporation's apportionable base, regardless of the geographical location of the group members. This use of the unitary business theory is referred to as "worldwide combined reporting" or "worldwide combination."

The constitutionality of worldwide combined reporting was upheld by the U.S. Supreme Court in *Container Corporation of America v. California Franchise Tax Board*, 463 U.S. 159, 103 S. Ct. 2933, 77 L. Ed. 2d 545 (1983), to the extent that the corporation which was doing business in California was a domestic corporation with foreign subsidiaries. The constitutionality of the converse situation, where the taxpayer-corporation is a domestic subsidiary of a foreign parent, has yet to be addressed by the U.S. Supreme Court. However, that issue is currently pending in Federal District Court in Chicago and may ultimately end up in the U.S. Supreme Court. See *Alcan Aluminum Ltd. v. Franchise Tax Board*, No. 84-C-6932, U.S. District Ct., N.D. Ill.

8. ARIZONA'S APPLICATION OF THE "UNITARY CONCEPT" AND COMBINED REPORTING.

8.1 *Arizona Applies the Unitary Business Theory on a "Domestic Combined Reporting Basis."*

Arizona has adopted the "domestic combined reporting" basis, sometimes referred to as the "water's edge" approach. See Regulations R15-2-1311 and R15-2-947.A.2 and Laws 1985, Chapter 109, which authorize only a "domestic combined reporting basis" and prohibits a "worldwide combined" reporting basis. Using such a "domestic combined reporting basis," only the income of the reporting corporation and its U.S. affiliates that are engaged in the same unitary business is included in the apportionable base. Income from foreign subsidiaries, including dividends, are excluded. Moreover, and for consistency purposes, values from foreign subsidiaries are not included in the denominators of the sales, payroll or property factors.

"80/20" Corporations. An "80-20" corporation was formerly defined as a domestic corporation which derived more than 80 percent of its federal gross income from sources outside the United States. This is also the federal definition of an "80-20" corporation. A.R.S. § 43-1101 now defines an "80-20" corporation as a domestic corporation with more than 80 percent of its property, payroll and sales outside the United States. An "80-20" corporation's values are excluded from the denominators of the three-factor formula.

8.2 *Arizona's Definition of "Combined Report."*

"Combined report" is defined by R15-2-1132.E as follows:

If a particular unitary trade or business is carried on by a taxpayer and one or more affiliated taxpayers united by a bond of direct or indirect ownership or control of more than fifty (50%) and a part of the businesses conducted in Arizona by one or more of the members of the group, the business income attributable to such a member or members shall be apportioned by multiplying the groups of unitary business income by the average of the property, payroll and sales factors. Those factors are determined by dividing the Arizona property, payroll and sales figures by the total property, payroll and sales figures of all the members of the unitary group. The property, payroll and sales factors are to be determined in accordance with the rules described in R15-2-1140 through R15-2-1147. The extent of the unitary business or group is limited to that business which is subject to the tax imposed by and computed pursuant to the Internal Revenue Code, except as provided in A.R.S. § 43-1132. R15-2-1132.E.

8.3 Arizona's Distinction Between a Consolidated Return and a Combined Report.

R15-2-947 distinguishes between consolidated returns and combined reports as follows:

A. Definitions. For purposes of this section the following definitions shall apply:

1. Consolidated return. A consolidated return is a single consolidated income tax return by a group of corporations meeting common ownership standards. The member entities may be engaged in diverse businesses and may or may not be operationally integrated. A consolidated return is a consolidation of the separate returns of each affiliated member of the group. Each member entity operating within and without Arizona will apportion income to Arizona based on a separate apportionment ratio relating only to that member. The net income and losses against member entities will be consolidated, offsetting losses against gains.

2. Combined return. A combined return is required to be filed by a group of commonly owned corporations or businesses which constitute a unitary business because the basic operations of the entities are integrated and interrelated. See R15-2-1132. The total income of the unitary group must be combined and allocated to Arizona for taxation purposes by means of one apportionment formula. The combined report has the same purpose and effect as the apportionment of the net income of a unitary business conducted by a single corporation. A group of corporations operating wholly in Arizona may be required to file a combined return if the group constitutes a unitary business. See A.R.S. § 43-942. In the case of such wholly owned Arizona corporations, 100% of the net income of the unitary business is allocated to Arizona.

B. This Section provides authority for the department to require a consolidated return under certain prescribed situations. This Section provides no authority for two or more taxpayers which operate wholly within Arizona to file a consolidated return. Two or more taxpayers which comprise a unitary business as defined in R15-2-1131 are required to file a combined, not a consolidated return. Discrete, separate and diverse taxpayers must file separate Arizona income tax returns.

8.4 Election to File Consolidated Arizona Returns on Same Basis as Federal Consolidated Returns.

Laws 1994, 2nd Reg. Session, Ch. 41 amended A.R.S. § 43-947 to allow corporate taxpayers an election to file consolidated Arizona income tax returns for taxable years beginning from and after December 31, 1993. In order to file an Arizona consolidated return the taxpayer must file a federal consolidated return. The taxpayer must include the same corporations in the Arizona consolidated return as in the federal consolidated return. The election to file on a consolidated basis is binding for all succeeding taxable years, unless the department consents to a change in filing method. The election must be accompanied by the written consent, signed by an officer, of each member of the affiliated group.

Taxpayers may also file retroactively on a consolidated basis by submitting amended returns on or before December 31, 1994, accompanied by properly executed consent forms. Taxpayers who wish to file on a consolidated basis for prior taxable years must file a consolidated Arizona return for the taxable year beginning from and after December 31, 1985, and for all succeeding taxable years.

Overpayments of Arizona tax resulting from retroactive consolidated filing for taxable years 1986 through 1993 are not refunded, but are allowed as a credit against future tax liabilities over a ten year period at a rate of 10 percent of the total credit per year. Overpayments remaining after the tenth year will be applied against the following year's tax

liability and any remaining balance will be refunded. *See* Arizona Corporate Tax Ruling CTR 94-10.

Laws 1995, Ch. 31, SB 1058 provides that an affiliated group that filed amended returns prior to December 31, 1994, making the consolidated return election, may amend those filings to include any Alaskan native corporations that are a part of the federal consolidated group. The prior years affected by this additional amended return provision are 1985 through 1992. New amended returns must be filed on or before December 31, 1995, making the election to include Alaskan native corporations.

Laws 1998, Ch. 89, SB 1244, allows corporations that meet all of the requirements for consolidation to file retroactive consolidated returns without securing the written consent of all former subsidiaries.

8.5 *Arizona's Test for Unitary Business.*

(1) *General.*

There are two basic requirements that must be satisfied in order to be considered a unitary business for Arizona income purposes. First, there must be a common ownership or control among the unitary group members of more than 50%. Second, there must be substantial operational integration between or among the unitary group members.

(2) *Regulations.*

The Department has detailed its two-fold test (common ownership or control and basic operational integration) in Regulation R15-2-1131.E.1:

1. *Single unitary trade or business and a combined report.* The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single unitary business if there is evidence to indicate that the basic operations of the components under consideration are integrated and interdependent.

The following definition of a single unitary business is based on economic substance and not form. Therefore, a unitary business may consist of one corporation or many corporations. If the unitary business consists of more than one corporation, a combined report by the entities comprising the unitary business is required by the Department. Components of the combined report must reconcile accounting periods and systems if they are not compatible. See R15-2-1132.E., F., for methods of filing a combined report and reconciling incompatible accounting periods. The entities comprising the unitary business must be united by a bond of direct or indirect ownership or control of more than fifty percent (50%) of the voting stock of a subsidiary corporation. There must be common management of the component parts of entities. At least some part of the unitary business must be conducted in Arizona.

The fundamental reason for defining a business as unitary is that its components in various states are so tied together at the basic operational level that it is truly difficult to determine the state in which profits are actually earned. Centralized top-level management, financing, accounting, insurance and benefit programs or overhead functions

by a home office are not sufficient characteristics in themselves for a business to be unitary without further analysis of the basic operations of component businesses.

An entity or group of entities is not a unitary business for apportionment purposes unless there is actual substantial interdependence and integration of the basic operations of the business carried on in more than one taxing jurisdiction. The potential to operate a component as part of the unitary business is not dispositive. In the manufacturing, producing or mercantile type of business, a substantial transfer of material, products, goods, technological data, processes, machinery, and equipment between the branches, divisions, subsidiaries or affiliates is required for an entity or group of entities to be defined as a unitary business.

A transfer of over twenty percent (20%) of the total goods annually manufactured, produced or purchased as inventory for processing and/or sale by the transferor, or over twenty percent (20%) of the total goods annually acquired for processing and/or sale by the transferee would be presumptive evidence of a unitary business. A smaller percentage of goods transferred may be indicative of a unitary business depending upon the presence of other characteristics indicating operational integration.

In a unitary service business, the operations of the various component parts of entities of the business are integrated and interrelated by their involvement with the central office or parent in delivering substantially the same service. The day-to-day operations of these components use the same procedures and technologies which are developed, organized, purchased and/or prescribed by the central office or parent. There usually is an exchange of employees among the component parts and centralized training of employees.

Generally speaking, a conglomerate composed of diverse businesses is not a single unitary business. However, a line or line of businesses within the conglomerate may be a unitary business if the operations of the components of the line are integrated and interrelated as described herein. The cost of centralized services and functions performed by the parent corporation for diverse subsidiaries may be specifically allocated to the respective subsidiaries.

While common ownership, common management and reconciled accounting systems of components are necessary threshold characteristics for a business to be considered a single unitary business, the presence of these three characteristics is not sufficient without evidence of substantial operational integration. Some of the factors of a single unitary business which indicate basic operational integration are:

1. the same or similar business conducted by components;
2. vertical development of a product by components, *i.e.*, sales, service, and repair financing;
3. horizontal development of a product by components, *i.e.*, sales, service, and repair financing;
4. transfer of materials, goods, products, and technological data and processes between components;
5. sharing of assets by components;
6. sharing or exchanging of operational employees by components;

7. centralized training of employees;
8. centralized mass purchasing of inventory, materials, equipment, technology relating to the on-going day to day operations of the components;
9. centralized development and distribution of technology relating to the on-going day to day operations of the components;
10. use of common trademark or logo at the basic operational level, centralized advertising with impact at the basic operational level;
11. exclusive sales-purchase agreements between components;
12. price differentials between components as compared to unrelated businesses;
13. sales or leases between components;
14. other contributions between components at the basic operational level.

All of the above factors need not be present in every unitary business, but factors indicating substantial integration at the basic operational level should be evident.

(3) *Talley Industries Case: "Operational Integration" Test.*

The question of whether a corporate group, that was not engaged in the same line of operational business, was a unitary business reviewed by the Arizona Court of Appeals in *State v. Talley Industries, Inc.*, 182 Ariz. 17, 893 P.2d 17 (App. 1994), review denied (April 1995). This case arose prior to Arizona's adoption of UDIPTA and must be viewed in that context. The taxpayer, Talley Industries, and its subsidiaries, were a corporate group but not engaged in the same line of operational business. However, the subsidiaries were subject to the taxpayer's pervasive centralized control. The Department of Revenue argued that that was not enough and that the subsidiaries and the taxpayer had to be engaged in the same line of business ("operational integration"). The taxpayer argued that all that was needed, at least prior to Arizona's adoption of UDIPTA, was "functional integration", meaning that there was centralized control and management, although the various components were not engaged in the same lines of business.

The Court agreed with the Department, holding that operational integration was required for unitary treatment. The Court reversed the Arizona Tax Court and Arizona Board of Tax Appeals which found functional integration sufficient and held that Talley and its subsidiaries were a unitary business.

(4) *The Woolworth Case: Operational Integration Test Upheld.*

F.W. Woolworth Co., Kinney Shoe Corp., and Kinney Service Corp. v. State of Arizona, 1 CA-TX 97-0007 (December 11, 1997), also involved the test to be used to determine whether a business is unitary, or not. Unfortunately, the Court of Appeals reaffirmed the *Talley* holding, concluding that the proper test in Arizona for a unitary business was the operational integration test, and not the functional integration test, or the three unities. The *Woolworth* case, unlike *Talley*, evolved years after Arizona adopted its Uniform Division of Income for Tax Purposes Act Regulations, which contained the fourteen factors for a unitary business. Given *Talley* and now *Woolworth*, it seems pretty clear that the Arizona unitary test is operational integration.

(5) *The Sperry Case: Finance Company is Unitary With Operating Parent.*

In *Sperry Corp. v. Arizona Dep't of Revenue*, 1994 Ariz. Tax LEXIS 27 (April 26, 1994) (Arizona State Board of Tax Appeals, Division 2, Docket No. 874-91-I), the Arizona Board of Tax Appeals was faced with the question of whether a finance company is unitary with the parent operating company. The Board concluded that under the facts of this case, the finance company was unitary.

Background. The Arizona Department of Revenue conducted an income tax audit of Sperry Corporation for the fiscal years 1980 through 1986. During that time, Sperry, also known as Sperry Rand Corporation, was engaged in a wide range of activities with its principal activity being the development, manufacturing, marketing and servicing of commercial and defense computer systems and equipment. It also manufactured specialized farm machinery and fluid power equipment.

Sperry filed on a separate return basis in Arizona through the end of its 1983-1984 fiscal year. Arizona adopted the Uniform Division of Income for Tax Purposes Act ("UDIPTA") in 1983, effective beginning January 1, 1984. Thereafter, Sperry filed on a combined return basis in Arizona excluding only its finance subsidiary, Sperry Financial Corporation (previously Sperry Rand Financial Corporation).

The major audit adjustment was the combination of Sperry's subsidiaries, including Sperry Financial, with Sperry, based on the Department's conclusion that Sperry and all its subsidiaries were engaged in a unitary business operation. Sperry objected to the combination of Sperry Financial and went through the administrative appeals process, ending up at the State Board level.

The State Board's Decision. The State Board upheld the Department's combination of Sperry Financial. Sperry argued that Sperry Financial was not properly includable in Sperry's unitary group because it was not operationally integrated with Sperry. After Arizona adopted UDIPTA, it promulgated regulations, A.A.C. R15-2-1131, which established an operational integration test for combination, as opposed to a functional integration test. The regulations first require common ownership, common management and reconciled accounting systems as threshold characteristics for a unitary business. The regulations further provide that the presence of these three characteristics is not sufficient by themselves without evidence of "substantial operational integration." Fourteen factors are then listed which indicate basic operational integration. Those factors include: the same or similar business conducted by components; horizontal development of a product by components; transfer of materials, goods, products and technological data and processes between components; sharing of assets by components; centralized mass purchasing of inventory, materials, equipment, exclusive sales-purchase agreements between components; sales or leases between components; etc. While all fourteen factors need not be present to indicate a unitary business, a significant number of them must be present to indicate substantial integration at the basic operational level.

Sperry argued that Sperry Financial did not meet the operational integration test established by the regulations, because it did not meet the bulk of the fourteen factors. Sperry contended that other than the same general trade name, the financing company had little in common with Sperry. Sperry Financial was not in the same business as Sperry. Sperry was a manufacturer; whereas, Sperry Financial was a financing company. Nor did Sperry Financial share in the technology or development of a common product. And of significant note, all transactions between Sperry Financial and Sperry were completed through arm's-length dealings at fair market value. There was no special pricing or

discounts given. The relationship between Sperry and Sperry Financial was arm's-length, the same as a relationship between a business and a bank.

The Department argued, however, and the Board took note of, the fact that Sperry Financial had an exclusive sales agreement to purchase receivables from Sperry and its subsidiaries. Sperry Financial did not purchase receivables or enter into financing arrangements with third-party, non-related entities. It dealt only with Sperry and its subsidiaries.

The Board's Test--Finance Company Is Unitary If Financing Of Customers Is An "Integral Part" Of Operating Company's Business. The Board found as a matter of fact that Sperry Financial was the financing arm that facilitates the sale of Sperry's products to its customers and concluded as a matter of law that where the financing of customers is an integral part of a parent company's business, the subsidiary credit or financing company performs a basic operating function and is unitary with the parent. The Board did not go down the list of the regulation's fourteen factors and determine which factors were met and which were not for purposes of determining whether the financing company was unitary. Rather, the Board concluded that a financing company performs a basic operating function where the financing of customers is an integral part of the parent's business, adopting what could be called an "integral part" test.

What is unclear is whether the Board's decision and reasoning applies only to "captive" finance companies that do business only with the operating company or whether it would apply to financing companies that also provide financing services to unrelated, third parties. It would seem that the Board's decision should not extend that far, given the Board's reliance and emphasis on the fact that Sperry Financial only dealt with its parent and not others.

Alternative Argument--Apportionment Formula. Sperry also argued that if the Board found Sperry Financial to be unitary, the three-factor apportionment formula should be modified because it does not fairly represent the combined group's business activity in Arizona. A.R.S. § 43-1148 provides specific authority for the use of other apportionment factors if the three-factor formula does not "fairly represent the extent of the taxpayer's business activity in this state."

Sperry contended that if its finance subsidiary was to be included in the combined report, the formula should include intangible property in both the numerator and the denominator of the property factor. As support for its contention, Sperry relied on *Sears, Roebuck & Co. v. Franchise Tax Bd. of California* (Cal. Super. Ct., No. C248013, December 14, 1983). Although this case was exactly on point, the Board rejected it because it is a California decision, reasoning that is not controlling in Arizona. The Board went on to conclude that Sperry did not satisfy the requirements of the statute, A.R.S. § 43-1148, by showing that the standard three-factor formula did not fairly represent the extent of Sperry's business activity in this state and therefore the Board upheld the use of the standard three-factor formula. Did the Board err by refusing to include intangibles in the property factor? The inclusion would have reduced the Arizona apportionment ratio because the situs of the finance company's intangibles would have been in its domiciliary state, New York. Clearly, the bulk of the financing company's assets were intangible in nature and, if it is to be a part of the unitary group, as the Board concluded, is the Arizona apportionment ratio skewed (upward) because of the non-inclusion of the intangibles?

8.6 Department of Revenue's Checklist for Unitary Business.

For audit purposes, the Department of Revenue has a checklist, or information document request, for determining whether a taxpayer is engaged in a unitary business with other corporate members. The checklist is comprised of the following sections:

- (1) Manufacturing function checklist;
- (2) Marketing function checklist;
- (3) General, administrative and selling function checklist.

Generally, upon an audit of a multi-state business that may be engaged in a unitary business operation with other related entities, the Department of Revenue will send the checklist to the taxpayer corporation, requesting information concerning the items on the checklist. The Department then uses the response to determine whether the taxpayer is engaged in a unitary business or not.

It should be noted that failure to provide the information requested may result in the imposition of the failure to provide information penalty under A.R.S. § 42-136.C. The penalty is quite hefty and is in the amount of 25% of the amount of any deficiency tax assessed by the Department concerning the audit assessment for which the information was required, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.