STATE OF ARIZONA

Department of Revenue
Office of the Director
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Director

CERTIFIED MAIL

The Director's Review of the Decision of the Hearing Officer Regarding:	)	**O R D E R**
[TAXPAYER] and SUBSIDIARIES	)	**Case No. 200400017-C**
ID No.	)	

On April 13, 2004, the Hearing Officer issued his decision regarding the protest of [TAXPAYER] and Subsidiaries (referred to herein collectively as "Taxpayer"). Taxpayer filed its appeal on May 13, 2004. As the appeal was timely, the Director of the Department of Revenue ("Director") issued a notice of intent to review the decision.

In accordance with the notice given the parties, the Director has reviewed the Hearing Officer's decision and now issues this Order.

STATEMENT OF CASE

Taxpayer elected to file an Arizona consolidated return with the filing of its original Arizona Form 120 for tax year 1995. [ARIZONA COMPANY], [CORPORATE PARTNER 1] and [CORPORATE PARTNER 2], members of the consolidated group, consented to be included in Taxpayer's Arizona consolidated return. The Corporate Income Audit Section of the Audit Division ("Division") issued a proposed assessment to Taxpayer for tax years 1995 through 1999 which resulted in a refund. Taxpayer timely protested. The Division subsequently modified the assessment increasing the amount of Taxpayer's refund. Taxpayer disagreed with the modification. The remaining issue before the Director is whether sales by [PARTNERSHIP] to [ARIZONA COMPANY] may be included in the numerator of the sales factor of the apportionment ratio of the consolidated group.

FINDINGS OF FACT

The Director adopts and incorporates into this order the undisputed findings of fact set forth in the decision of the Hearing Officer as follows:

1. [ARIZONA COMPANY] [ENGAGED IN BUSINESS] in Arizona.

2. [ARIZONA COMPANY]'s operations are wholly within Arizona.

3. [ARIZONA COMPANY] and [CORPORATE PARTNER 1] are wholly owned subsidiaries of [TAXPAYER].

4. [CORPORATE PARTNER 2] is a wholly owned subsidiary of [CORPORATE PARTNER 1].

5. [CORPORATE PARTNER 1] owned a 10% partnership interest in [PARTNERSHIP] and [CORPORATE PARTNER 2] owned a 3.5% partnership interest in [PARTNERSHIP].

6. [PARTNERSHIP] is a general partnership that operates a [A BUSINESS] in the State of Washington.

7. [PARTNERSHIP] sold [PRODUCT] to [ARIZONA COMPANY] during the audit period.

8. [PARTNERSHIP] ships [PRODUCT] via common carrier to [ARIZONA COMPANY] in [CITY], Arizona.

9. [CORPORATE PARTNER 1], [CORPORATE PARTNER 2] and [PARTNERSHIP] are not engaged in business activities in Arizona beyond the solicitation of sales.

CONCLUSIONS OF LAW

The Director makes the following Conclusions of Law:

1. Corporations are subject to Arizona income tax on income earned from sources within Arizona. A.R.S. § 43-102(A)(5).

2. Corporations that have income from sources both within and without Arizona must allocate and apportion their income pursuant to A.R.S. §§ 43-1131 *et. seq.*

3. A.R.S. §§ 43-1131 *et. seq.* provide for the apportionment of Taxpayer's business income by multiplying the business income by a fraction, the numerator of which is

the property factor, the payroll factor and two times the sales factor, and a denominator of four.

4. The payroll and property factors are not at issue in this appeal.

5. The sales factor is a fraction the numerator of which is the total sales of the Taxpayer in Arizona and the denominator of which is the total sales of the Taxpayer everywhere during the tax period. A.R.S. § 43-1145.

6. The term "sales" is defined as the gross receipts derived by the Taxpayer from transaction and activity in the normal course of business. A.R.S. § 43-1131.5 and A.A.C. R15-2-1145.A. [1]

7. Taxpayer in this case elected pursuant to A.R.S. § 43-947 to file consolidated corporate income tax returns to Arizona.

8. A.R.S. § 43-947 provides in relevant part:

> A. On or before the due date, including any extensions, for filing the original return for taxable years beginning from and after December 31, 1993, the common parent of an affiliated group may ***elect to consolidate the taxable income of all members of the affiliated group, regardless of whether each member is subject to tax under this title*.**
>
> B. The affiliated group shall file a consolidated return for the year of election and for each succeeding taxable year, unless the department consents to a change of filing method. … .
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> * * *
>
> E. The Arizona gross income of an Arizona affiliated group is the consolidated federal taxable income of the affiliated group.

[1] References to statutes and administrative rules are to those as they existed during the period at issue.

> F. The affiliated group shall allocate and apportion its income to this state in the manner prescribed in chapter 11, article 4 of this title. ***For the purposes of allocation and apportionment of income, the Arizona affiliated group is considered to be and shall be treated as a single taxpayer.*** (Emphasis added.)
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> * * *

9. By electing to file a consolidate return under A.R.S. § 43-947, Taxpayer agreed to the treatment of the affiliated group as a single taxpayer. A.R.S. § 43-947.F.

10. To apportion the affiliated group's income, a single apportionment formula is calculated using the apportionment factors prescribed in Chapter 11, Article 4 of Title 43. The apportionment formula is applied against the income of the affiliated group as if it were a single taxpayer. All Arizona property, payroll, and sales of the affiliated corporations will be included in the numerator of the apportionment ratio regardless of whether each of the corporations have or had nexus within the state on a separate basis. Arizona Corporate Tax Ruling CTR 94-10.

11. The numerator of the sales factor of the apportionment formula includes the total sales of the taxpayer (all members of the affiliated group) in this state during the tax period. A.R.S. § 43-1145.

12. Sales are considered to be in Arizona if the property is shipped or delivered to a purchaser within Arizona regardless of the f.o.b. point or other conditions of sale. A.A.C. R15-2-1146.A.1.a.

13. Corporate partners in a partnership must include their proportionate share of the partnership's property, payroll and sales in the partner's apportionment factors in determining the apportionment ratio of the corporate partner. Arizona Corporate Tax Rulings CTR 94-2 and CTR 94-1.

14. [CORPORATE PARTNER 1] and [CORPORATE PARTNER 2], two of the corporate members of the Taxpayer's affiliated group, owned partnership interests in [PARTNERSHIP]. [CORPORATE PARTNER 1] and [CORPORATE PARTNER 2] were required to include their proportionate share of [PARTNERSHIP]'s sales in their apportionment factors in determining the Taxpayer's apportionment ratio. Arizona Corporate Tax Rulings CTR 94-2 and CTR 94-1.

15. The sales of [PRODUCT] by [PARTNERSHIP] to [ARIZONA COMPANY] were shipped to Arizona, and were thus sales in this state. Those sales were required to be included in the numerator of the Taxpayer's sales factor. A.A.C. R15-2-1146.A.1.a.

16. Arizona sales by a corporation which does not itself conduct business in Arizona, but which is part of a unitary group of corporations which operate in Arizona and file a combined return to Arizona, may be attributed to Arizona. *Airborne Navigation Corporation v. Arizona Department of Revenue*, Ariz. Bd. of Tax Appeals, Docket No. 395-85-I (February 5, 1987).

17. Arizona sales by a corporation which does not itself conduct business in Arizona, but which is a member of a group of corporations that has elected consolidated tax treatment under A.R.S. § 43-947, may be attributed to Arizona.

18. The Division's determination with regard to the numerator of Taxpayer's sales factor is proper.

DISCUSSION

The issue to be decided is whether sales by [PARTNERSHIP] to [ARIZONA COMPANY] should be included in the numerator of the Arizona sales factor of the apportionment ratio of the consolidated group. Taxpayer advanced numerous arguments that sales by [PARTNERSHIP] should not be included in the Arizona sales factor.

A. The Arizona apportionment ratio was calculated correctly.

Taxpayer argues that the calculation of [PARTNERSHIP]'s apportionment factors is to be undertaken at the partnership level and not at the consolidated return level. In this case, Taxpayer elected pursuant to A.R.S. § 43-947 to file consolidated corporate income tax returns to Arizona. A.R.S. § 43-947.F requires the affiliated group to allocate and apportion its income to Arizona in the manner prescribed by Chapter 11, Article 4 of Tile 43, which consists of A.R.S. §§ 43-1131 through 43-1150 (UDITPA). A.R.S. § 43-947.F further provides that for purposes of allocation and apportionment of income, the Arizona affiliated group is considered to be and shall be treated as a single taxpayer. Taxpayer consented to this treatment by making the election under A.R.S. § 43-947 to file consolidated returns.

Taxpayer was engaged in business in Arizona beyond the mere solicitation of sales. [ARIZONA COMPANY], a member of the affiliated group, [ENGAGED IN BUSINESS] in Arizona. Because the affiliated group is treated as a single taxpayer, whether or not individual members of the consolidated group conducted their business in Arizona is not relevant.

Two members of the affiliated group were partners in a partnership. Corporate partners must include their proportionate share of the partnership's property, payroll and sales in the partner's apportionment factors in determining the apportionment ratio of the corporate partner. Arizona sales include sales of property shipped or delivered to a purchaser within Arizona. [PARTNERSHIP]'s Arizona sales of [PRODUCT] to [ARIZONA COMPANY] were thus properly included in the numerator of the affiliated group's sales factor.

B. Public Law 86-272 does not prohibit including the Arizona sales in the numerator of the affiliated group's sales factor.

Taxpayer argues that P.L. 86-272 precludes the inclusion of [PARTNERSHIP]'s Arizona sales in the group's apportionment ratio. P.L. 86-272 in general prohibits a state from imposing its income tax on an out-of-state business if the only activity of that business in the taxing state is the solicitation of sales. That is not the situation here. Taxpayer (the

affiliated group) clearly does more in Arizona than simply solicit orders. One of the members, [ARIZONA COMPANY], [ENGAGES IN BUSINESS] in Arizona. By making the consolidation election under A.R.S. § 43-947, Taxpayer agreed to be treated as a single taxpayer for Arizona corporate income tax purposes.

Even without a consolidation election, Public Law 86-272 does not expressly prohibit a state from using the income of a non-taxable entity for purposes of apportionment if another member of a unitary group of which it is a part conducts the requisite in-state activity. This question was addressed by the Arizona Board of Tax Appeals in *Airborne Navigation Corporation v. Arizona Department of Revenue.* Airborne Navigation had contended that the Department was precluded by Pub. L. No. 86-272 from including a member's Arizona destination sales in the numerator of the "sales factor" because that member did not itself conduct business in Arizona.

The Board held that if some member of the group conducts the requisite degree of activity within the state, that member of the unitary group has subjected itself to the taxing authority of that state, and apportionment of the group's income to that taxpayer does not circumvent the spirit of P.L. 86-272, as long as the apportionment formula is reasonable. The Board concluded that Airborne should not be able to qualify for the immunity provided by P.L. 86-272, as there were business activities performed in this State by Airborne outside of mere solicitation; Airborne had a business presence in Arizona by way of manufacturing. Taxpayer's election under A.R.S. § 43-947, as well as principles of unitary reporting, require that the group be taken as a whole. P.L. 86-272 simply does not preclude including [PARTNERSHIP]'s Arizona sales in the sales factor. *Airborne Navigation Corporation v. Arizona Department of Revenue.*

C. The California Board of Equalization decisions in Appeal of Joyce, Inc., and Appeal of Huffy Corp. do not apply.

Taxpayer's arguments are also based on a standard set forth by the California Board of Equalization in *Appeal of Joyce, Inc.*, 66-SBE-070, 1966 WL 1411 (November 23, 1966) and *Appeal of Huffy Corp.*, 99-SBE-005, 1999 WL 386938 (April 22, 1999). In *Joyce*, the California Board of Equalization held that under P.L. 86-272 the net income of a member

of a unitary group derived from sources within California should not be includible in the unitary group's apportionment formula if the only business activities of the member within the state were activities protected by P.L. 86-272. That standard is not applicable here.

First, *Joyce* involved a unitary group, and did not involve *an affiliated group* which affirmatively elected to be treated as a single taxpayer. Given the Taxpayer's election under A.R.S. § 43-947, the California Board of Equalization's holdings in *Joyce* and *Huffy* are not relevant. Taxpayer cannot agree to treat the group as a single taxpayer, and then isolate the activities of separate members when it believes it is to its advantage.

Second, in *Airborne Navigation* the Arizona Board of Tax Appeals held that Arizona could include sales by a corporation which did not itself conduct business in Arizona, but which was a part of a unitary group that operated in and file a combined return to Arizona. In reaching its decision in *Airborne Navigation*, the Board discussed *Container Corporation of America v. Franchise Tax Board,* 103 S.Ct. 2933 (1983). In *Container Corporation*, the United States Supreme Court observed:

> The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities- even on a proportional basis- unless there is a "'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'". . . At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported "unitary business" unless at least some part of it is conducted in the State. . . (Citations omitted.) 103 S.Ct. at 2940.

The Board in *Airborne Navigation* correctly concluded there is no constitutional requirement for Arizona to follow the *Joyce* rule. Similarly, it is not necessary to apply the *Joyce* rule to this case and exclude the Arizona sales by [PARTNERSHIP] from the numerator of the sales factor. In fact, California itself abrogated the *Joyce* rule in the California Board of Equalization's decision in *Appeal of Finnigan Corporation,* 88-SBE-022 (August 25, 1988), Opinion on Rehearing, 88-SBE-022-A (January 24, 1990). *Finnigan* involved a different, but closely related, issue to that in *Joyce.* The Board of

Equalization held in *Finnigan* that non-California-destination sales made by a California corporation should be attributed to the destination states for sales factor purposes, rather than "thrown back" to California, because a unitary affiliate of the seller was taxable in the destination states even though the seller itself was not. Under the *Joyce* rule, those sales would have "thrown back" to California.

The holding in *Finnigan,* analogous to the holding in *Airborne Navigation*, was the state of law in California until 1999, when the Board of Equalization again changed its mind in the *Appeal of Huffy Corp.*, 99-SBE-005, 1999 WL 386938 (April 22, 1999). In *Huffy*, the Board determined it should abandon the *Finnigan* rule, and return to the *Joyce* rule. However, the Board made its decision in *Huffy* prospective only for income years beginning on or after April 22, 1999. This prospective treatment indicates that the Board did not conclude that the position taken in *Finnigan* was legally deficient.

The question whether *Huffy* could be applied prospectively only was also considered by the California Court of Appeals in *Citicorp North America, Inc., v. Franchise Tax Board*, 83 Cal.App.4th 1403, 100 Cal.Rptr.2d 509 (2000). Citicorp argued that the *Finnigan* rule violated unitary principles as well as the commerce clause, the due process clause and the equal protection clauses of the United States Constitution. The Court disagreed.

In reaching its conclusion, the Court stated that the mere fact that other jurisdictions did not follow the *Finnigan* rule was not a valid basis for the court to disregard the considered decision of the Board. The Court recognized that valid principled reasons support the rationale of *Joyce* as well as the rationale of *Finnigan.* The Court, citing *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.* 2 Cal.4th 708, 8 Cal.Rptr.2d 31, 829 P.2d 279 (1992), stated that it found no error in the *Finnigan* approach and that the constitution did not mandate the use of any particular method of apportionment so long as the method used was not arbitrary.

The authority in other states is divided on this issue. This was recognized in *Great Northern Nekoosa Corp., et al. v. State Tax Assessor,* 675 A.2d 963, 966 (1996) ("Other jurisdictions have considered the relationship between the 'throwback rule' and combined

reporting. The authority is divided.") Among other authorities, the Court in *Nekoosa* cited the Arizona Board of Tax Appeals decision in *Airborne Navigation Corp. v. Department of Revenue,* as being consistent with the unitary theory of corporate income taxation.

In reaching its determination that *Finnigan* did not violate constitutional standards, the Court in *Citicorp* concluded that the Franchise Tax Board was not taxing out of state income by including the California income of Citibank (South Dakota). Instead, the Board was apportioning income attributable to California. Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction. Therefore there were no constitutional violations in applying *Finnigan.*

The *Finnigan* approach is also consistent with unitary principles. *Citicorp,* 83 Cal.App.4th at 1414-15, 100 Cal.Rptr.2d at 519-20. As the Board of Equalization itself noted in the Opinion on Rehearing in *Finnigan,* it was *Joyce* that contravened fundamental unitary theory in two important respects. First, by forbidding the assignment of sales to the state of destination in situations where at least one member of the unitary group is taxable in that state, but the actual seller is not, the *Joyce* rule defeats the basic purpose of the sales factor, which is to reflect the markets for the unitary business's goods and services. Second, by focusing on the state's jurisdiction to tax the seller as a separate corporate entity, the rule elevates form over substance by yielding a different apportionment result dependent solely on whether the unitary business is conducted by several corporations or only by one.

The fact that other states have followed the *Joyce* rule does not require Arizona to change its long standing practice. Exposure to duplicative taxation resulting from a lack of uniformity among the states does not present a constitutional issue. Companies doing business in more than one state may be exposed to different taxing rules. The Constitution does not mandate that every state treat every item of income alike and assign the apportionment of sales in a uniform manner. *Citicorp,* 83 Cal.App.4th at 1425, 100 Cal.Rptr.2d at 527.

In summary, a review of the applicable Arizona provisions, including A.R.S. § 43-947, A.R.S. § 43-1145, former A.A.C. R15-2-1146.A.1.a, CTR 94-10, CTR 94-1 and CTR 94-2, as well as a review of applicable case law such as *Container Corporation*, do not indicate that the Department has violated P.L. 86-272 in the present case, or that the Department should change its long standing interpretation, upheld in 1987 by the Arizona Board of Tax Appeals in *Airborne Navigation.* It was clearly appropriate to include [PARTNERSHIP]'s sales to [ARIZONA COMPANY] in the numerator of the sales factor even though neither [PARTNERSHIP] nor its corporate partners were engaged in business activities in Arizona beyond the solicitation of sales and making sales into Arizona. Therefore, although pursuant to A.R.S. § 42-1004.C. the Department is not bound by decisions of the Arizona Board of Tax Appeals, it seems prudent to continue to follow the Board's decision in *Airborne Navigation.*

O R D E R

The Hearing Officer's decision dated April 13, 2004 is affirmed and the Taxpayer's claim for refund denied.

This decision is the final order of the Department of Revenue. Taxpayer may contest the final order of the Department in one of two manners. Taxpayer may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140, Phoenix, AZ 85007 or may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty (60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 9th day of December, 2004.

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director

Certified original of the foregoing
mailed to:

[TAXPAYER]
Attention: President
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JEH:st

cc: Corporate Income Tax Audit Section
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