

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)	DECISION OF
)	HEARING OFFICER
[REDACTED])	
)	
FEIN [REDACTED])	Case No. 200600088-C
_____)	

A hearing was held on October 3, 2006 in the matter of the protest of [REDACTED] (Taxpayer) to an assessment of corporate income tax and interest by the Corporate Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2000.

FINDINGS OF FACT

The evidence and the parties' joint listing of facts establish the following. [REDACTED] is a [REDACTED] corporation headquartered in [REDACTED], [REDACTED]. [REDACTED] is engaged primarily in [REDACTED] in the United States. During 2000, [REDACTED] had Arizona locations in [REDACTED], [REDACTED] and [REDACTED]. Taxpayer filed a consolidated Arizona corporate income tax return for 2000. [REDACTED] is the parent company of the consolidated group.

[REDACTED] is a wholly owned subsidiary of [REDACTED] and is a member of [REDACTED]'s consolidated group of corporations. [REDACTED] was incorporated in [REDACTED] in [REDACTED] and was an inactive corporation prior to 2000. [REDACTED] had no income or expense prior to 2000. During 2000, [REDACTED] received income of \$[REDACTED] derived from an [REDACTED] (Agreement) by

and between [REDACTED] and [REDACTED] which are independent and unrelated companies.

From 1994 through 1997, [REDACTED] made a number of acquisitions within its industry. On [REDACTED] [REDACTED] entered into the Agreement with [REDACTED]. [REDACTED] would merge into a [REDACTED] entity and the [REDACTED] entity would be the surviving entity. [NEXT THREE SENTENCES REDACTED]. Both companies agreed to extend the deadline for the merger from [REDACTED] until [REDACTED].

[SENTENCE REDACTED]. On [REDACTED] [REDACTED] filed suit against [REDACTED] for payment of an \$[REDACTED] termination fee in connection with the failed merger. The suit also included claims for compensatory and punitive damages for [REDACTED]'s alleged breach of contract. On [REDACTED] [REDACTED] and [REDACTED] reached an agreement whereby [REDACTED] would withdraw its suit and [REDACTED] would pay Taxpayer \$[REDACTED]. On [REDACTED] [REDACTED] paid Taxpayer \$[REDACTED] pursuant to [REDACTED] of the Agreement. The payment was comprised of a termination fee of \$[REDACTED] plus \$[REDACTED] as reimbursement for Taxpayer's out-of-pocket expenses directly attributable to the proposed acquisition of Taxpayer. Since [REDACTED] had assigned the right to receive the \$[REDACTED] to [REDACTED], [REDACTED] transferred the funds directly to [REDACTED]. [REDACTED] loaned the entire \$[REDACTED] to [REDACTED] under an interest-bearing revolving promissory note dated January 27, 2000.

On its 2000 federal consolidated income tax return, Taxpayer [NEXT THREE SENTENCES REDACTED]. On its 2000 Arizona consolidated income tax return, Taxpayer treated the \$[REDACTED] termination fee as nonbusiness income.

The Section audited Taxpayer for tax year 2000 and issued a proposed assessment for 2000 that included tax and interest. No penalties were imposed. Taxpayer timely protested the assessment. The parties agree that there are two issues to be decided. The first issue is whether the \$[REDACTED] termination fee that [REDACTED] received as the result of the failed merger with [REDACTED] constitutes business or nonbusiness income. In its assessment, the Section determined that this income is business income to be apportioned to Arizona. Taxpayer argues that this income is nonbusiness income and may not be apportioned to Arizona and may not be taxed by Arizona. The second issue is whether the assessment is invalid if the Department failed to comply with A.R.S. § 42-2076 when it issued the proposed assessment.

CONCLUSIONS OF LAW

The presumption is that an additional assessment of income tax is correct and the burden is on the taxpayer to overcome such presumption. *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 191 P.2d 729 (1948). Taxpayer has provided insufficient evidence to overcome the presumption.

A.R.S. § 43-947.A states that the common parent of an affiliated group may elect to consolidate the taxable income of

all the members of the affiliated group "regardless of whether each member is subject to tax under this title." A.R.S.

§ 43-947.B provides, in general, that this is accomplished by filing a consolidated return to Arizona. As previously noted, Taxpayer elected to file a consolidated return to Arizona, which included [REDACTED]. A.R.S. § 43-947.E provides that the "Arizona gross income of an Arizona affiliated group is the consolidated federal taxable income of the affiliated group." On its 2000 federal consolidated income tax return, Taxpayer [REDACTED]. A.R.S. § 43-947.F provides that the affiliated group shall allocate and apportion its income to Arizona in the manner prescribed by Chapter 11, Article 4 of Title 43, which consists of A.R.S. §§ 43-1131 through 43-1150. A.R.S. § 43-1139 provides that business income shall be apportioned to Arizona by using an apportionment formula consisting of the property factor, the payroll factor and the sales factor. The resolution of the first issue in this case hinges on whether the \$[REDACTED] termination fee received by [REDACTED] as the result of the failed merger with [REDACTED] constitutes business or nonbusiness income.

A.R.S. § 43-1131.1 defines "business income" to mean:

. . . 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. § 43-1131.4 defines "nonbusiness income" to mean all income other than business income.

A.A.C. R15-2D-501.A, prior to its amendment effective October 5, 2001, provides:

Business and non-business income defined. "Business income" is 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. . . In essence, all income from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration, the income of the taxpayer is business income unless clearly classified as non-business income.

A.A.C. R15-2D-501.B, prior to its amendment effective October 5, 2001, defines "nonbusiness income" to mean all income other than business income.

Arizona law, at A.R.S. § 43-1131.1 and A.A.C. R15-2D-501, provides two alternative tests to determine whether income constitutes business income. The first is the "transactional test" under which the question is whether the activity or transaction which gave rise to the income occurred "in the regular course of the taxpayer's trade or business." The second test is the "functional" test. Under this test, income is business income if "the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Also see Arizona Corporate Tax Ruling CTR 94-12 which discusses the transactional and functional tests in determining what is business and

nonbusiness income for an Arizona affiliated group that files an Arizona consolidated income tax return. CTR 94-12 recognizes that Arizona has adopted both the transactional test and functional test for business income. It is well settled that an agency's interpretation of a statute is entitled to great weight. *Marlar v. State*, 136 Ariz. 404, 666 P.2d 504 (App. 1983). Clearly, Arizona has adopted both the "transactional" test and the "functional" test.

At the hearing, the parties focused on CTR 94-12. CTR 94-12 points out that income on an Arizona consolidated return is classified as either business or nonbusiness income. The ruling states in part that in order to identify income as business or nonbusiness, one must identify whether it is income arising from transactions and activities in the regular course of the taxpayer's trade or business. The ruling points out that there may be multiple unrelated trades or businesses within the Arizona affiliated group and states:

In determining whether income is business or nonbusiness, one may look to a single corporation, a part of a corporation, or a group of corporations sufficiently integrated to constitute a business. If a transaction is within the regular course of a trade or business, the income from that transaction will be business income. If a transaction is not within the regular course of a trade or business, the income from that transaction will be nonbusiness income.

The parties seem to agree that [REDACTED] is not a part of Taxpayer's integrated [REDACTED] business. Nevertheless, CTR 94-12 provides that in determining whether income is business or nonbusiness, one may also look to a single corporation of the affiliated group, in this case, [REDACTED]. The testimony indicates that [REDACTED] was formed in [REDACTED] to hold an investment in an operation in [REDACTED], but this investment never came to fruition. Thereafter, [REDACTED] was an inactive corporation until [REDACTED] when Taxpayer's board of directors decided to put the \$[REDACTED] termination fee in [REDACTED]. This decision of Taxpayer's board must have occurred prior to [REDACTED]'s payment of the \$[REDACTED] termination fee because the parties' joint listing of facts states at paragraph 28 that "[b]ecause [REDACTED] had assigned to [REDACTED] the right to receive the \$[REDACTED], [REDACTED] transferred the funds directly to [REDACTED]." Taxpayer's board decided that [REDACTED]'s business purpose was to receive and hold the \$[REDACTED] termination fee. The facts establish that in 2000, [REDACTED]'s regular course of trade or business was to receive and hold the \$[REDACTED] termination fee, which Taxpayer [REDACTED] on its 2000 federal consolidated income tax return. This is the only third-party income of [REDACTED]. Since the receipt and holding of the \$[REDACTED] termination fee is within the regular course of [REDACTED]'s trade or business, it is

business income under the transactional test and is thus apportionable to Arizona. In light of this conclusion, it is not necessary to address whether the functional test is also met in this case.

Taxpayer suggests that this conclusion runs afoul of nexus requirements. However, as previously noted A.R.S. § 43-947.A states that the common parent of an affiliated group may elect to consolidate the taxable income of all the members of the affiliated group "regardless of whether each member is subject to tax under this title." Taxpayer elected to file a consolidated return to Arizona and is therefore bound by the provisions of A.R.S. § 43-947.

The second issue is whether the assessment is invalid if the Department failed to comply with A.R.S. § 42-2076 when it issued the proposed assessment. A.R.S. § 42-2076 provides:

At the time when the department issues a deficiency assessment or denies all or part of a claim for refund, the department shall also provide the taxpayer and, if applicable, the taxpayer's authorized representative with a written explanation of all adjustments made, including the specific statutory, regulatory and judicial bases for the adjustments.

There is no language in A.R.S. § 42-2076 that would invalidate a proposed assessment if the Department fails to comply with A.R.S. § 42-2076. A.R.S. § 42-2076 provides no consequence should the

Department fail to comply with it. Taxpayer's argument that the proposed assessment is invalid is therefore without merit.

As to the interest portion of the assessment, A.R.S. § 42-1123.C provides that if the tax "or any portion of the tax is not paid" when due "the department shall collect, as a part of the tax, interest on the unpaid amount" until the tax has been paid. For Arizona purposes, therefore, interest is a part of the tax and generally may not be abated unless the tax to which it relates is found not to be due for whatever reason. The tax was due in this case and the associated interest cannot be abated.

Based on the foregoing, the Section's proposed assessment is affirmed.

DATED this 10th day of October, 2006.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by
certified mail to:

[REDACTED]

Copies of the foregoing mailed to:

[REDACTED]

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue

Corporate Audit Section