

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)	DECISION OF
)	HEARING OFFICER
[REDACTED])	
)	Case No. 200600082-C
FEIN [REDACTED])	
_____)	

A hearing was held on October 17, 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 years ending June 30, 1997 through June 30, 2001. Taxpayer's opening post-hearing memorandum was timely filed by postmark dated December 7, 2006. The Section's response post-hearing memorandum was timely filed on January 22, 2007. Taxpayer's reply post-hearing memorandum was timely filed by postmark dated April 2, 2007. The Section's supplemental post-hearing memorandum was timely filed on May 11, 2007. Taxpayer's reply supplemental post-hearing memorandum was timely filed on June 11, 2007. Therefore, this matter is ready to be decided.

FINDINGS OF FACT

The parties' joint listing of facts establishes the following. [REDACTED] is incorporated in [REDACTED] and is the common parent of the affiliated group. [REDACTED]'s executive offices are located in [REDACTED] and [REDACTED] is its commercial domicile. Taxpayer is primarily a [REDACTED] company focused on [REDACTED].

Taxpayer filed consolidated Arizona income tax returns for tax years ending June 30, 1997 through June 30, 2001. The Section audited Taxpayer for these years and issued a proposed assessment that included tax and interest. No penalties were imposed. Taxpayer timely protested the assessment. Taxpayer and the Department subsequently entered into a partial closing agreement.

The parties agree that the remaining issues all involve the classification by Taxpayer of gains/losses arising from certain transactions as nonbusiness income. [REDACTED] entities recorded disputed business income transactions. For purposes of this decision, the Section's Exhibits titled "[REDACTED]" and "[REDACTED]" will be used as the framework for addressing the primary disputed transactions in this case. In its reply memorandum, Taxpayer concedes that the \$[REDACTED] million gain labeled as "[REDACTED]" should have been reported as business income in [REDACTED]. Therefore, this item is no longer at issue.

[REDACTED] sold and leased [REDACTED] and provided [REDACTED] services. All revenue from the [REDACTED] operations was reported as business income on the Arizona consolidated returns at issue. During the tax year ending [REDACTED], Taxpayer approved a plan to spin off its [REDACTED] operations. The disputed item, which is the \$[REDACTED] million gain associated with the sale of its [REDACTED] product line in the tax year ending [REDACTED], was reported as nonbusiness income on the Arizona consolidated return. For the tax year ending

[REDACTED], [REDACTED] recorded a federal taxable loss of \$[REDACTED] million which was recorded as business on the Arizona corporate income tax return. During the tax year ending [REDACTED], the spin off was effected through the tax-free distribution of one share of [REDACTED] common stock for each share of common stock of Taxpayer. Taxpayer retained ownership of approximately [REDACTED]% of the shares of [REDACTED]. During the tax year ending [REDACTED], Taxpayer sold its remaining [REDACTED]% ownership of [REDACTED] and recorded a \$[REDACTED] million capital loss [REDACTED]. This loss was treated as a business loss on the Arizona corporate income tax return.

The issue to be decided is whether the disputed transactions gave rise to business or nonbusiness income. In its assessment, the Section determined that all this income is business income. Taxpayer argues that all this income is nonbusiness income and may not be apportioned to Arizona and may not be taxed by Arizona. Additionally, Taxpayer argues that Arizona's version of the Uniform Division of Income for Tax Purposes Act sets forth only a transactional test for determining whether income is taxable as business income, and not a separate and independent functional test.

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 this presumption.

As previously noted, Taxpayer filed consolidated returns to Arizona for the years at issue. 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 accompanied by written consents to the election signed by each member of the affiliated group. 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." 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 all business income shall be apportioned to Arizona by using an apportionment formula consisting of the property factor, the payroll factor and the sales factor. A.R.S. § 43-1134 provides that capital gains, to the extent they constitute nonbusiness income, shall be allocated pursuant to A.R.S. § 43-1136. A.R.S. § 43-1134 provides that royalties, to the extent they constitute nonbusiness income, shall be allocated pursuant to A.R.S. § 43-1138.

The resolution of the issue in this case hinges on whether the disputed transactions gave rise to 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.

The Arizona Administrative Code, at A.A.C. R15-2D-501.A (prior to its amendment in 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.* (Emphasis added.)

A.A.C. R15-2D-501.B, prior to its amendment in 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." For instance, A.A.C. R15-2D-503 provides that gain or loss from the sale of assets and gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property "constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business." Clearly, this is a functional test. 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. It is well settled that an agency's interpretation of a statute or regulation 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.

As previously noted, A.A.C. R15-2D-503 addresses gain or loss from the sale of assets and gain or loss from the sale, exchange or other disposition of real or tangible or intangible

personal property. A.A.C. R15-2D-503, prior to its amendment in 2001, provides:

Gains or losses from sales of assets, gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income *if the property while owned by the taxpayer was used in the taxpayer's trade or business.* However, if such property was utilized for the production of non-business income or otherwise was removed from the property factor for a substantial period of time before the year of its sale, exchange or other disposition, the gain or loss will constitute non-business income. Five years or more shall be considered a substantial period of time. (Emphasis added.)

With regard to royalties, A.A.C. R15-2D-506, prior to its amendment in 2001, provides:

Royalties. Patent and copyright royalties and other royalties and licensing fees are business income where the patent or copyright with respect to which the royalties and other royalties and licensing fees were received arose out of or was created in the regular course of the taxpayer's trade or business operations or *where the purpose for acquiring and holding the patent or copyright is related to such trade or business operations.* (Emphasis added.)

In support of its position that the disputed transactions gave rise to business income, the Section focuses on Arizona Corporate Tax Ruling 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 ruling then indicates that former A.A.C. R15-2-1131.A sets forth a transactional test and a functional test for business income.

The aforementioned law must now be applied to the facts in this case. With regard to the holding companies, the parties seem to agree that the holding companies listed on the Section's [REDACTED] are not a part of Taxpayer's [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. With regard to the holding companies, the disputed transactions involve sales of [REDACTED]. The business of each of the holding companies was to hold the respective assets or property. That was in fact the business of each of the holding companies. A.A.C. R15-2D-503 provides in part that gains from the sale of assets and property

constitute business income if the property, while owned by the taxpayer, was used in the taxpayer's business. The assets and property were used in each of the holding companies' respective businesses because their business was to hold the asset or property. Therefore, the gains from the sales of these assets and property, including [REDACTED] constitute business income.

Taxpayer cites several cases for its argument that capital gains from the sale of a minority interest in other corporations is not apportionable business income. 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 consolidated returns to Arizona pursuant to A.R.S. § 43-947. Each member of the affiliated group consented to be included therein. Therefore, Taxpayer is bound by the provisions of A.R.S. § 43-947.

Taxpayer argues that its royalty income from the [REDACTED] patents is nonbusiness income because [REDACTED] patents are not an integral part of Taxpayer's [REDACTED] business and Taxpayer did not create or use any of the [REDACTED]. However, A.A.C. R15-2D-506 provides in part that royalties are business income where the purpose for acquiring and holding the patent or copyright is related to the trade or business operations. The business of the holding companies was to hold the patents or trademarks, therefore any income derived from holding the patents or trademarks is business income.

With regard to the sale of [REDACTED]'s [REDACTED] business by [REDACTED], all revenue from this business was reported as business income on Taxpayer's Arizona consolidated returns. For the tax year ending [REDACTED], [REDACTED] recorded a [REDACTED] loss of \$[REDACTED] million which was recorded as business on the Arizona corporate income tax return. When Taxpayer sold its remaining minority ownership interest in [REDACTED], it treated the \$[REDACTED] million loss as business. There is no evidence to conclude that [REDACTED]'s [REDACTED] business was utilized for the production of nonbusiness income. To the contrary, Taxpayer reported all income/loss from this business as business income/loss on Taxpayer's consolidated returns. It must therefore be concluded that the gain from the sale of [REDACTED]'s [REDACTED] business is business income pursuant to A.A.C. R15-2D-503.

As to the disputed items recorded in [REDACTED] that are not conceded by the Section (see document titled "[REDACTED]"), there is insufficient evidence to conclude that any of the income is nonbusiness income. As previously noted, A.A.C. R15-2D-501.A provides that the income of the taxpayer is business income unless it is clearly classified as nonbusiness income. A review of the parties' submissions indicates that none of these disputed items are clearly classified as nonbusiness income.

Based on the foregoing, Taxpayer's protest of the items not conceded by the Section is denied.

DATED this 15th day of June, 2007.

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]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Audit Section