BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of [REDACTED] I.D. No. [REDACTED]	))))))	DECISION OF HEARING OFFICER Case No. 201200235-C

A hearing was held on February 12, 2013 in the matter of the protest of [REDACTED] (Taxpayer) to a refund denial by the Corporate Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for taxable period ending [REDACTED]. At the hearing it was agreed that the record remain open to allow the parties time to provide additional information.

Taxpayer and the Section timely filed their respective opening and response memoranda. Taxpayer did not submit a reply memorandum. This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayer designed, manufactured and installed [REDACTED] products and integrated [REDACTED] solutions and services.
2. Taxpayer was owned by [REDACTED].
3. In 2006 Taxpayer was commercially domiciled in [REDACTED].
4. In 2006 [REDACTED] sold its stock in Taxpayer to an unaffiliated third-party purchaser for $[REDACTED].
5. [REDACTED] and the purchaser made an election under the Internal Revenue Code to treat the sale of the stock as a sale by Taxpayer of its assets.
6. The purchase price for Taxpayer's assets included goodwill valued at $[REDACTED].
7. Taxpayer reported the purchase price, including the goodwill, as business income subject to apportionment.

8. In the computation of its Arizona apportionment percentage, Taxpayer did not include the gross receipts from the deemed sale of the assets, including goodwill, in the sales factor.

9. In September 2009 Taxpayer filed an amended income tax return including the gross receipts from the deemed sale of its assets, including goodwill, in the denominator of the Arizona sales factor.

10. Taxpayer requested refund of Arizona corporate income taxes of $[REDACTED].

11. The Section denied Taxpayer's claim for refund by notice dated January 11, 2010.

12. Taxpayer timely protested the denial stating that the gross receipts from the sale of the business assets, including goodwill, should be included in total sales for purposes of computing the Arizona sales factor.

13. The Section contends that the gain on any goodwill should be excluded from the sales factor.

CONCLUSIONS OF LAW

1. Any corporate taxpayer having income from business activity which is taxable both within and without Arizona is required to allocate and apportion its net income as provided in Title 43, Ch. 11, Art. 4. Arizona Revised Statutes (A.R.S.) § 43-1132(A).

2. A taxpayer's business income is apportioned to the states where the taxpayer operates. Title 43, Ch. 11, Art. 4.

3. 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. A.R.S. § 43-1131(1).

4. For purposes of administration, the income of a taxpayer is business income unless clearly classifiable as nonbusiness income. Arizona Administrative Code (A.A.C.) R15-2D-501(A).

5. All transactions and activities of a taxpayer that are the result of or incidental to the operations of a particular trade or business of the taxpayer are transactions and activity arising in the regular course of, and constitute integral parts of, a trade or business. A.A.C. R15-2D-501(B).

6. Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage and may be due to the name or reputation of a trade or business, or any other factor. Treas. Reg. § 1.1060-1(b)(2)(ii).

7. Goodwill denotes acceptance by customers of a company's products, a good relationship between a company and its customers and suppliers, and a general standing of a business in the community or industry. West's Tax Law Dictionary, 1999 Edition.

8. Goodwill is a by-product of good business operations.

9. Taxpayer's goodwill was built up over time and did not arise independent of Taxpayer's business operations.

10. Taxpayer's receipts from the deemed sale of its assets, including goodwill, constituted business income.

11. A taxpayer's business income is apportioned to Arizona based on an apportionment ratio comprised of the taxpayer's property, payroll and sales factors.

12. The purpose of the sales factor is to tax an entity for the benefits it receives by exploiting a market in a state. *Walgreen v. Arizona Department of Revenue,* 209 Ariz. 71, 97 P.3d 896 (2004).

13. The sales factor includes the gross receipts of the taxpayer derived from transactions and activity in the regular course of a trade or business not specifically allocated. A.R.S. § 43-1131(5); A.A.C. R15-2D-101.
14. The sales factor excludes substantial amounts of gross receipts that arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, such as a factory or plant. A.A.C. R15-2D-903(1).
15. While the rule specifically refers to fixed assets used in the trade or business, the reasoning for excluding such incidental receipts from the sales factor apply equally to the related sale of the goodwill that was generated by the trade or business. *See,* California FTB Legal Ruling No. 97-1 (1997).[1]
16. Taxpayer's deemed sale of its assets, including goodwill, was not a transaction in the regular course of its trade or business of designing, manufacturing and installing [REDACTED] products and integrated [REDACTED] solutions and services.
17. Taxpayer received substantial gross receipts for its deemed sale of its assets, including goodwill.
18. The Section properly excluded the gross receipts from Taxpayer's deemed sale of its assets, including goodwill, from the sales factor.
19. The Section's denial of Taxpayer's claim for refund for taxable period ending [REDACTED] is upheld.

DISCUSSION

Taxpayer's parent company sold its stock in Taxpayer to an unaffiliated third party. The parties elected to treat the sale as a sale by Taxpayer of its assets. Taxpayer reported the receipts as apportionable income but excluded the receipts from its sales factor. Taxpayer thereafter filed an amended return that included the receipts

[1] While the FTB Legal Ruling is not precedential, the reasoning of the ruling is legally sound and persuasive. The holding in Letter Ruling 97-1 was later codified in Regulation in 2001.

from the deemed sale of its assets in the denominator of the sales factor and requested a refund. The Section denied Taxpayer's refund claim and Taxpayer timely protested.

The question presented is whether the receipts from the sale of Taxpayer's goodwill should be included in or excluded from the denominator of Taxpayer's sales factor. For the reasons that follow we hold that the Section properly excluded the goodwill from the sales factor.

Goodwill is the name given to the value of an active business that is in excess of the value of its tangible property. The value of goodwill is built up over time. It is the product of all deployments of land, labor, capital and managerial skill undertaken by a taxpayer over time and in all locations where the business of the taxpayer is carried on.

While goodwill is an intangible asset, it is not a separate item of intangible property such as stocks or bonds. Goodwill does not exist independent of the business that created the extra value and is inseparable from the business as a whole.

Taxpayer's primary argument is that goodwill is an intangible asset and the receipts must therefore be sourced to the state where most of the income producing activity occurred. However, before considering the proper manner of including receipts allocable to goodwill in the numerator of the sales factor, we must first determine whether Taxpayer's receipts allocable to goodwill should be included in the sales factor at all.

The purpose of the sales factor is to tax an entity for the benefits it receives by exploiting a market in a state. However, A.A.C. R15-2D-903(1) excludes from the sales factor substantial amounts of gross receipts that arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, such as a factory or plant.

As FTB Legal Ruling 97-1 stated, the exclusion of receipts from an incidental or occasional sale of a fixed asset from the sales factor is based on the rationale that such gross receipts do not fairly reflect the taxpayer's day-to-day business activity and therefore cause excessive income to be apportioned to the state where the occasional sale took place. This is especially so if the growth of built-in appreciation occurs over a substantial period of time.

The same rationale is applicable to goodwill which does not exist independent of the business that created the extra value and is inseparable from the business as a whole. Neither the incidental sale of fixed assets used in the regular course of Taxpayer's trade or business nor the incidental sale of the goodwill that was built up by Taxpayer's trade or business fairly reflect Taxpayer's day-to-day business activity. As FTB Legal Ruling 97-1 pointed out, there is no logical basis for distinguishing between fixed assets and intangibles. Taxpayer's gross receipts from its deemed sale of its assets, including goodwill, should be excluded from the sales factor.

Based on the foregoing, the Section's denial of Taxpayer's claim for refund for taxable period ending [REDACTED] is upheld.

DATED this 31st day of May, 2013.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[REDACTED]
Hearing Officer

Original of the foregoing sent by certified mail to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Appeals Section

Copy of the foregoing mailed to:

[REDACTED]