BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	**DECISION OF HEARING OFFICER**
[TAXPAYER]	)	
	)	**Case No. 200600035-C**
FEIN [REDACTED]	)	

A hearing was held on May 11, 2006 in the matter of the protest of [REDACTED] (Taxpayer) to an assessment of corporate income tax and the denial of refunds by the Corporate Audit Section (Section) of the Arizona Department of Revenue (Department) for tax years ending January 31, 1999 through February 3, 2002. Taxpayer's opening post-hearing memorandum was timely filed on July 10, 2006. The Section's response post-hearing memorandum was timely filed on August 9, 2006. Taxpayer's reply post-hearing memorandum was timely filed on September 7, 2006. Therefore, this matter is ready to be decided.

FINDINGS OF FACT

For the tax year ending February 3, 2002, Taxpayer was [REDACTED]. Taxpayer was incorporated in 1978 in Delaware and Georgia is Taxpayer's state of commercial domicile. Taxpayer's executive offices are located in [REDACTED], Georgia.

The Section audited Taxpayer for the years ending January 31, 1999 through February 3, 2002 and issued a proposed assessment for these years that included tax and interest. No penalties were imposed. Taxpayer timely protested the proposed assessment. The Section subsequently modified the assessment to

incorporate federal changes for tax years ending January 30, 2000 and January 31, 2001. The Section subsequently modified the assessment again to change the components of the payroll factor to agree with Taxpayer's position in light of additional information submitted by Taxpayer. Taxpayer disagreed with the modified assessments.

Taxpayer filed amended returns for tax years ending January 30, 2000, January 28, 2001 and February 3, 2002 which included a change to the unitary group. The Section denied the refund claims and Taxpayer protested the refund denials. According to the Section, the refund claims denied by the Section aggregate $[REDACTED].

There are two remaining issues to be decided. The first issue is whether [REDACTED], [REDACTED], [REDACTED] and [REDACTED] are part of Taxpayer's unitary group. In its audit, the Section accepted as correct the unitary group reflected by Taxpayer in its original combined corporate income tax return filed for the year ending January 30, 2000. The Section objects to the subsequent removal of the aforementioned four subsidiaries in Taxpayer's amended returns. The second issue is whether a dividend received deduction is allowed for the real estate investment trust (REIT) dividends paid by [REDACTED] to [REDACTED].

The evidence establishes the following. [REDACTED] is a wholly owned subsidiary of [REDACTED]. [REDACTED] was formed to be a holding company by [REDACTED] in 1999 in a tax-free reorganization. [REDACTED] obtained ownership of its initial

assets through a contribution of cash and real property pursuant to the provisions of I.R.C. § 351. The real property consisted of a substantial number, but not 100%, of [REDACTED]. [REDACTED], in 1999, then contributed these assets to [REDACTED] pursuant to the provisions of I.R.C. § 351. [REDACTED] has no revenue associated with third parties, it does not maintain a separate office in Delaware, on February 3, 2002 [REDACTED] had no employees and the President of [REDACTED], who reports to [REDACTED], is also the President of [REDACTED].

[REDACTED] is a wholly owned subsidiary of [REDACTED] and is a REIT. [REDACTED] was incorporated in 1998 and was formed by [REDACTED] to consolidate the real property. As previously noted, [REDACTED] contributed cash and real property to [REDACTED] pursuant to the provisions of I.R.C. § 351. The rental payments charged by [REDACTED] to [REDACTED] were determined by an unrelated third party. There is no revenue associated with third parties. For years ending January 28, 2001 and February 3, 2002, [REDACTED] paid dividends to [REDACTED]. On its federal returns, [REDACTED] took a deduction for the dividends paid to [REDACTED] pursuant to I.R.C. § 857(b)(2)(B). For Arizona corporate income tax purposes, [REDACTED] did not report the dividend income pursuant to A.R.S. § 43-1122.4. [REDACTED] does not maintain a separate office. On February 3, 2002, [REDACTED] had no employees. The Board of Directors and officers of [REDACTED] are predominantly officers of [REDACTED].

[REDACTED] is a wholly owned subsidiary of [REDACTED] that was formed by [REDACTED] in 1991 in a tax-free reorganization to perform intercompany financing activities. [REDACTED] obtained ownership of its initial assets through a contribution of capital pursuant to the provisions of I.R.C. § 118. [REDACTED] charges [REDACTED] and others interest on loans based upon a determination made by an unrelated bank. There is no revenue associated with third parties. [REDACTED] maintains a separate office in Texas. On February 3, 2002, [REDACTED] had one employee. The Board of Directors and officers of [REDACTED] are predominantly officers of [REDACTED].

[REDACTED] was incorporated in Delaware and is a wholly owned subsidiary of [REDACTED]. [REDACTED] was formed by [REDACTED] in 1991 in a tax-free reorganization to enable certain trade names, registered trademarks and service marks to be held in a separate entity whose principal function is the maintenance, enhancement, management and protection of these assets. [REDACTED] obtained ownership of these assets in 1991 through an assignment from [REDACTED], which was based on an outside appraisal. [REDACTED] charges [REDACTED] and others royalties to use these assets based upon outside appraisals. In 1999, the royalty rate was increased from 1.5% to 4% of monthly gross sales. [REDACTED] maintains a separate office in Delaware. On February 3, 2002, [REDACTED] had three employees. The President of [REDACTED] reports to [REDACTED]. Of the four disputed subsidiaries, only [REDACTED] had third-party revenue.

CONCLUSIONS OF LAW

A.R.S. § 43-102.A.5 states in part that it is the intent of the legislature 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. § 43-307.A provides in part that "[e]very corporation subject to the tax imposed by this title shall make a return to the department." A.R.S. § 43-942 authorizes the Department to require the filing of a combined report in the case of two or more corporations owned or controlled directly or indirectly by the same interests in order to prevent evasion of taxes or to clearly reflect income.

As to the unitary business issue, the Arizona Administrative Code, prior to its amendment effective October 5, 2001, provides in pertinent part at A.A.C. R15-2D-401.A:

* * *

> **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 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. . . . **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 20% of the total goods annually manufactured, produced or purchased as inventory for processing and/or sale by the transferor, or over 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 or 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.
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> 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.* . . . (Emphasis added.)

The rule then lists several factors of a single unitary business which indicate basic operational integration.

The Section accepted as correct the unitary group reflected by Taxpayer in its year ending January 30, 2000 combined corporate income tax return as originally filed. The Section objects to the subsequent removal of the four disputed subsidiaries in Taxpayer's amended returns on the basis that, in relation to the unitary group accepted by the Section, they are substantially operationally integrated and interdependent and interrelated. In support of its position, the Section relies on the following: the four disputed subsidiaries were formed from existing assets, they have no significant outside activity, they could not exist independently, they have no separate commercial viability, they are part of Taxpayer's core business operation and they perform functions previously performed on an internal basis before their corporate formation. Simply stated, the Section's position is that Taxpayer cannot carve out from one, existing unitary group internal activities being provided to the existing unitary group and designate these activities as a collection of new, stand-alone unitary groups.

Taxpayer's position is that, under *State ex rel. Arizona Department of Revenue v. Talley*, 182 Ariz. 17, 893 P.2d 17 (App. 1994), there are no basic operational ties between the four disputed subsidiaries and Taxpayer. Taxpayer asserts that [REDACTED], [REDACTED] and [REDACTED] are viable, separate operating companies and all of their dealings with Taxpayer in Arizona are done at arm's length. Therefore, Taxpayer argues, the four disputed subsidiaries cannot be combined with Taxpayer under Arizona law.

The evidence indicates that the threshold characteristics of common ownership, common management and reconciled accounting systems of components are present in this case. However, the presence of these three characteristics is not sufficient to establish that a business is unitary. There must also be evidence of substantial interdependence, integration and ties at the basic operational level among the entities. *See* A.A.C. R15-2D-401.A and *Talley*. Neither *Talley* nor the Arizona Administrative Code precludes a finding that a business is unitary if transactions occur between the entities at arm's length.

[REDACTED]'s royalty income is directly related to [REDACTED]. [REDACTED] created the asset and continues to use it. The value of [REDACTED] is entirely dependent upon the continuous efforts of [REDACTED] to enhance its brand recognition. Without [REDACTED]'s effective use of the trademarks, [REDACTED] would have no income. Additionally, [REDACTED] is in the [REDACTED] business. [REDACTED] is a

trademark company that manages intellectual property related to [REDACTED]'s [REDACTED] business. The revenue-generating activity of [REDACTED] is the licensing of the trademarks. The vast majority of [REDACTED]'s income is derived from this activity and is directly earned from [REDACTED]. This revenue-generating activity is indicative of substantial operational integration and operational ties and constitutes substantial operational interdependence. It must therefore be concluded that [REDACTED] is an integral part of Taxpayer's unitary business.

[REDACTED] is a REIT that is in the business of holding only the real property (retail stores) used by [REDACTED]. [REDACTED] has no employees. The primary revenue-generating activity of [REDACTED] is the rental income generated by leasing the [REDACTED] retail stores to [REDACTED]. [REDACTED]'s store rental income is directly related to [REDACTED]'s [REDACTED] sales. Without [REDACTED] occupying the stores to sell its products, it would generate no cash and [REDACTED] would have no revenue. This revenue-generating activity is indicative of substantial operational integration and operational ties and constitutes substantial operational interdependence. It must therefore be concluded that [REDACTED] is an integral part of Taxpayer's unitary business.

[REDACTED] is a holding company that only owns [REDACTED], the REIT. [REDACTED] has no employees. The primary revenue-generating activity of [REDACTED] is the rental income generated by leasing the [REDACTED] retail stores to [REDACTED]. As in

the case of [REDACTED], this revenue-generating activity is indicative of substantial operational integration and operational ties and constitutes substantial operational interdependence. [REDACTED]'s revenue is dependent on [REDACTED]'s revenue which is dependent on [REDACTED]'s revenue. It must therefore be concluded that [REDACTED] is an integral part of Taxpayer's unitary business.

[REDACTED] is an intercompany financing company that is in the business of borrowing from and loaning money to members of Taxpayer. The revenue-generating activity of [REDACTED] is the origination of intercompany loans. [REDACTED]'s interest income is directly related to [REDACTED]'s intercompany cash needs for its [REDACTED] business. [REDACTED] is completely dependent on Taxpayer for its income. This revenue-generating activity is indicative of substantial operational integration and operational ties and constitutes substantial operational interdependence. It must therefore be concluded that [REDACTED] is an integral part of Taxpayer's unitary business.

As previously noted, the second issue is whether a dividend received deduction is allowed for the REIT dividend paid by [REDACTED] to [REDACTED]. The Section's position is as follows. As part of the combination process, the Section eliminated the REIT dividend paid by one entity to another entity because both entities were included in the unitary group. The dividend was eliminated because the dividend is an intercompany transaction and must therefore be eliminated to avoid distortion pursuant to A.A.C. R15-2D-405. Because the dividend is eliminated in

forming the unitary group, the Section argues, there is no dividend to deduct as an Arizona dividend received deduction. Taxpayer argues that the dividend adjustments made by the Section are contrary to Arizona law. Taxpayer argues that Arizona must start with [REDACTED]'s federal taxable income for the years at issue, which includes the dividends paid deduction under I.R.C. § 857(b)(2)(B), for purposes of determining [REDACTED]'s Arizona gross income. Taxpayer then argues that Arizona must allow [REDACTED] the dividends received deduction under A.R.S. § 43-1122.4 for the dividends it received from [REDACTED].

[REDACTED] and [REDACTED] have been determined to be part of Taxpayer's unitary business and thus must be included in Taxpayer's combined returns filed to Arizona. A.A.C. R15-2D-405 provides:

> **Members of a combined or consolidated return shall eliminate intercompany amounts included in the group's income, expense, and apportionment factors when necessary to avoid distortion of the group's Arizona taxable income.**

The Section has provided sufficient evidence to show that the REIT dividend, which is an intercompany transaction, must be eliminated pursuant to A.A.C. R15-2D-405 to avoid distortion of the group's Arizona taxable income. Arizona Corporate Tax Ruling CTR 99-7 does not apply to the facts in the present case. CTR 99-7 holds in part that "[c]orporate REIT beneficiaries will be entitled to the Arizona corporate dividend received deduction if the corporate recipient meets the control or ownership

requirements of A.R.S. § 43-1122(5).” Although the aforementioned control or ownership requirements of A.R.S. § 43-1122(5) are met in this case, CTR 99-7 does not address the situation, which occurs in the present case, where the corporate REIT and beneficiary are part of the same unitary group. In such a case, A.A.C. R15-2D-405 applies and the dividend must be eliminated as an intercompany transaction and therefore there are no longer any dividends to deduct.

Additional assessments of income tax, as well as refund denials, are presumed to be 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 failed to show that the Section’s refund denial and most recent modified assessment are improper.

In its opening post-hearing memorandum, Taxpayer asserts that to combine the four entities at issue violates the due process and commerce clauses of the U.S. Constitution. However, the United States Supreme Court has held that a taxing authority’s apportionment is not to be disturbed unless the taxpayer proves by clear and cogent evidence that the income attributed to the state has led to a grossly distorted result or is in fact out of all appropriate proportion to the business transacted in that state. *Hans Rees’ Sons v. North Carolina,* 283 U.S. 123 (1931); *Norfolk & Western Railway Co. v. Missouri State Tax Commission,* 390 U.S. 317 (1968); *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978). Taxpayer has not shown that the Section’s position leads to a grossly distorted result or is in

fact out of all appropriate proportion to the business transacted by Taxpayer in Arizona.

In accordance with the foregoing, Taxpayer's protests are denied.

DATED this 15th day of September, 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