STATE OF ARIZONA

Department of Revenue
Office of the Director
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CERTIFIED MAIL [REDACTED]

The Director's Review of the Decision of the Hearing Officer Regarding: **[REDACTED]** ID No. [REDACTED]	**O R D E R** **Case No. 200600091–C**

On May 14, 2007, the Hearing Officer issued his decision regarding the protest of [REDACTED] ("Taxpayer"). Taxpayer timely filed an appeal; therefore, the Director of the Department of Revenue 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

The Corporate Audit Division ("Division") issued a deficiency assessment to Taxpayer for tax years 1996 through 2000 Taxpayer protested the assessment, and the Hearing Officer denied the protest. On appeal, Taxpayer argues the gain on the sale of stock is not apportionable because: (1) the stock sold is in a foreign subsidiary and, by Arizona's water's edge statute, the latter cannot be part of a unitary group; (2) the holding company which owned and sold the stock is not engaged in any business operations, and, therefore is not operationally integrated with Taxpayer's regular trade or business and is not unitary with the same; (3) the Division cannot "look through" the holding company to the business activities of the foreign subsidiary it holds to determine the holding company's regular trade or business; and (4) even if the holding company was unitary with Taxpayer, the gain from the sale of the foreign subsidiary stock is a nonbusiness gain. Further, Taxpayer argues that it would be unconstitutional to tax the gain because the fourth prong of the *Complete Auto* test is not met.

References in this Order to the Arizona Administrative Code (A.A.C.) are to the Code as it existed during the years at issue.

Findings of Fact

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

1. [REDACTED] (Parent) is incorporated in [REDACTED] and has its executive offices in [REDACTED] and [REDACTED]a is its commercial domicile.
2. Taxpayer develops, manufactures, markets, distributes and services [REDACTED].
3. [REDACTED] (Foreign Subsidiary) was incorporated in [REDACTED] in 1985 and has conducted business operations in [REDACTED]. Parent's trade name and trademarks are used in [REDACTED] under license to Foreign Subsidiary.
4. Foreign Subsidiary makes modifications and adaptations to [REDACTED] originally developed by Parent to make the product marketable in [REDACTED].
5. [REDACTED] (Holding Company) is a wholly owned subsidiary of Parent, is incorporated in [REDACTED] and was included in the federal corporate income tax return of Parent for the years at issue.
6. Holding Company is a holding company that holds a majority of the common stock of Foreign Subsidiary.
7. Until February, 1999 Holding Company owned [REDACTED]% of Foreign Subsidiary. The remainder was owned by Foreign Subsidiary's employees ([REDACTED]%), [REDACTED] ([REDACTED]%) and [REDACTED] ([REDACTED]%).
8. Taxpayer filed combined Arizona income tax returns for tax years ending May 31, 1996 through May 31, 2000, the years at issue. Holding Company was included in Taxpayer's Arizona combined corporate income tax returns for the years at issue.
9. In February, 1999 Holding Company sold [REDACTED]% of Foreign Subsidiary on the [REDACTED] over-the-counter market and retained an [REDACTED]% ownership.

10. For tax year ending May 31, 1999 Taxpayer classified the gain recognized by Holding Company of $[REDACTED] as nonbusiness income on the Arizona return.
11. In April, 2000 Holding Company sold an additional [REDACTED]% of the outstanding shares of Foreign Subsidiary on the [REDACTED] Stock Exchange and retained a [REDACTED]% ownership share.
12. For tax year ending May 31, 2000 Taxpayer classified the gain recognized by Holding Company of $[REDACTED] as nonbusiness income on the Arizona return.
13. The Division audited Taxpayer and issued proposed assessments for these years that included tax and interest only. Taxpayer timely protested the assessment.
14. Subsequently there were several modifications of the assessment and Taxpayer and the Department entered into two partial closing agreements.
15. A significant portion of the proceeds from the sales of stock of Foreign Subsidiary was loaned by Holding Company to Parent and was used by Parent to buy back Parent's common stock listed on the NASDAQ in the United States.
16. Parent's [REDACTED} was modified by Foreign Subsidiary and there is no indication that Parent allows non-controlled entities to modify and sell Parent's [REDACRED] as their own.
17. A letter to Taxpayer's shareholders written by the [REDACTED] of Parent and included in the [REDACTED] Annual Report discusses the functioning of Parent and its subsidiaries. Taxpayer has not denied the accuracy of the statements in this letter.
18. Based on the letter to the shareholders: 1) Taxpayer used a global network and a single global database "to integrate all aspects of doing business" where everybody is connected and all the information is in one place and the systems integration problems global businesses have are eliminated by having that one global database which works for all countries; 2) in globalizing its information technology, Taxpayer "gained huge economies of scale not only in labor, but also in purchasing computer equipment and network services"; 3) Taxpayer's new Internet sales system made its entire sales process more uniform and automated resulting in "a global system so the sales process is the same all over the world" ; 4) with "interdependency" of

Taxpayer's new unified computer systems "came cooperation, specialization and economies of scale"; 5) information technology, marketing, sales and services like education were provided free to country managers resulting in standardized business processes; (6) the introduction of Internet technology led to Taxpayer's globalization, which, in turn, led to operational inefficiencies melting away; and (7) Taxpayer has "become a company of interdependent business groups."

19. Holding Company held the stock in Foreign Subsidiary for the purpose of controlling it to provide part of the global market Taxpayer sought to provide its customers.
20. Taxpayer was "a company of interdependent business groups."

Conclusions of Law

The Director adopts and incorporates into this order from the conclusions of law set forth in the decision of the Hearing Officer and makes other conclusions as follows:

1. The threshold characteristics of a unitary business, common ownership, common management and reconciled accounting systems are present with Taxpayer and Holding Company and Foreign Subsidiary.
2. There is a vertical development of products, substantial transfer of products, technological data and processes between Parent and subsidiaries. Global sales and databases are a sharing of assets by components. Taxpayer's Parent and subsidiaries use a common trademark or logo at the basic operational level. There is a unitary group.
3. The letter from the [REDACTED] to Shareholders in the [REDACTED] Annual Report demonstrates that Foreign Subsidiary was not operated independently from Parent, and Parent did contribute to or participate in the marketing of Foreign Subsidiary's [REDACTED].
4. Foreign Subsidiary is a part of a network that develops, manufactures, markets, distributes and services [REDACTED]. Foreign Subsidiary is integrated with Parent and other operational companies at the basic operational level.
5. A foreign subsidiary can be a part of the unitary group but its income is not taxable because of Arizona's water's edge statute.

6. Holding Company is performing a unitary function for the group by holding the stock of the lower tier operating company which would be a unitary business asset of Parent if it were held by Parent directly. Holding Company loaned much of the proceeds of its stock sales to Parent. Holding Company is an integral part of Taxpayer's unitary group.
7. Arizona has adopted two independent tests, the "transactional" test and the "functional" test, for determining whether income is business income.
8. The "functional" test is that "the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."
9. "The acquisition, management and disposition" of the stock in Foreign Subsidiary constituted "integral parts of the [T]axpayer's regular trade or business operations".
10. Pursuant to A.R.S. § 43-1131.1 and A.A.C. R15-2-1131, Holding Company's gains from sales of the common stock it owned in Foreign Subsidiary is apportionable business income under the functional test.
11. The Taxpayer's activities in Arizona were related to Foreign Subsidiary's activities.
12. Taxpayer has not shown that the measure of the tax the Division seeks to impose bears no relationship to the Taxpayer's presence or activities in Arizona.
13. The assessment does not violate the fourth prong of the *Complete Auto Transit* test.
14. Taxpayer did not provide sufficient evidence to prove that extraterritorial values are being taxed by Arizona in the proposed assessment.
15. The taxpayer has the burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed. *Container Corporation of America v. Franchise Tax Board,* 103 S.Ct. 2933, 2940 (1983).
16. Even if Foreign Subsidiary and Holding Company were not unitary in the enterprise sense with Parent, the controlling ownership Holding Company has in Foreign Subsidiary constitutes an operational function or purpose. Therefore, the stock in Foreign Subsidiary is a unitary asset of Parent and the gain or loss form its sale may be taxed as a part of the apportionable income the same as any other business income of the combined group.

17. Taxpayer has not shown that the assessment of the gain from the sale of Foreign Subsidiary stock as apportionable income violates the United States Constitution.

18. The assessment is proper.

DISCUSSION

Taxpayer filed its Arizona corporate income tax returns on a combined basis for 1996 through 2000, including Holding Company in the unitary group, but showing its gain on the sale of stock in Foreign Subsidiary as nonbusiness income not allocable to Arizona. After an assessment in which the stock gains were taxed as business income, Taxpayer has argued that the Holding Company is not even in the unitary group.

"The unitary business rule, then essentially rests on the difficulty of determining the amount of income attributable to various states of producing, refining, manufacturing, transporting, buying, selling, and the like, conducted in different states." *State ex rel. Arizona Dept. of Revenue* v. *Talley Industries, Inc.*, 182 Ariz. 17, 25, 893 P.2d 17 (Ariz.App. 1994) review denied (Apr 25, 1995). "The recognition that an enterprise is not unitary unless, inter alia, there is a substantial interdependence of basic operations among the various affiliates or branches of the business provides a quantifiable, objective test of the unitary business." (quoting I Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, ¶ 8.11[5], at 8-92 (2d ed. 1993)) *State ex rel. Arizona Dept. of Revenue* v. *Talley Industries, Inc.*, 182 Ariz. 24

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. If Holding Company is a part of Taxpayer's unitary group, the Department may require its income to be included in the combined return.

Unitary combination

Threshold Characteristics

A.A.C. R15-2-1131.E states the threshold characteristics of a unitary business are common ownership, common management and reconciled accounting systems of components. From the joint stipulations of fact it is clear that characteristics of common

ownership and reconciled accounting systems exist between Parent, Holding Company and Foreign Subsidiary. The Hearing Officer found that there was common management as well and Taxpayer has not denied this. The threshold characteristics are present.

Substantial Integration at the Basic Operational Level

A.A.C. R15-2-1131.E states that to establish a unitary business not only must there be the threshold characteristics of common ownership, common management and reconciled accounting systems of components, but there must also be evidence of substantial operational integration. The rule lists several factors which would indicate basic operational integration, stating that all of the "factors need not be present in every unitary business." Some of the factors are: vertical development of a product by components, such as manufacturing, distribution, and sales; transfer of materials, goods, products, and technological data and processes between components; sharing of assets by components; use of common trademark or logo at the basic operational level; any other integration between components at the basic operational level.

Taxpayer states that Holding Company is not operationally integrated with Taxpayer's regular trade or business. A letter to Taxpayer's shareholders written by the [REDACTED] of Parent (the "Shareholder Letter") and included in the [REDACTED] Annual Report discusses several factors that indicate substantial integration at the basic operational level between Parent and other entities that constitute Taxpayer. Some of those factors include: 1) using a global network and a single global database "to integrate all aspects of doing business" where everybody is connected and all the information is in one place and the systems integration problems global businesses have are eliminated by having that one global database which works for all countries; 2) in globalizing its information technology, Taxpayer "gained huge economies of scale not only in labor, but also in purchasing computer equipment and network services"; 3) Taxpayer's new Internet sales system made its entire sales process more uniform and automated resulting in "a global system so the sales process is the same all over the world" ; 4) with "interdependency" of Taxpayer's new unified computer systems "came cooperation, specialization and economies of scale"; and 5) information technology, marketing, sales and services like education were provided free to country managers resulting in

standardized business processes. The Shareholder Letter states that the introduction of Internet technology led to Taxpayer's globalization which led to operational inefficiencies melting away and concludes that Taxpayer has "become a company of interdependent business groups."

Foreign Subsidiary

The information in the Shareholder Letter describes a substantially interdependent and integrated business at the basic operational level. The question is what companies are involved in this unitary business. The letter describes a global net work of sales and systems - a "company of interdependent business groups". In its memoranda Taxpayer describes Foreign Subsidiary as operating by itself in its own market, [REDACTED], without assistance from Taxpayer in personnel, research and development and marketing. While Taxpayer does not deny that the Shareholder Letter is accurate, the description given of Foreign Subsidiary in the memoranda ignores the activities and resources provided to all areas of the world described in the letter.

Taxpayer argues that it is a manufacturing business. A.A.C. R15-2-1131.E.1 provides:

> [i]n 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

The flow of goods, products, technological data and processes between Parent and the other operational companies such as Foreign Subsidiary is clear In the Shareholder Letter. The global database, the information technology, the internet sales system, the unified computer systems and the use of Parent's trademark are a flow of value from Parent to Foreign Subsidiary and the other operational subsidiaries. Additionally, Foreign Subsidiary uses the products created by Parent and modifies them to create the products it sells. There is a substantial transfer of products, technological data, processes between Parent and the subsidiaries including Foreign Subsidiary.

Based on Taxpayer's description of Foreign Subsidiary's modifications of Parent's [REDACTED], there appears to be vertical development of a product and transfer of products, and technological data. The global sales and databases are a sharing of assets by components. There is a common trademark or logo at the basic operational level.

When the facts presented by the Taxpayer in this case are taken in the context of the resources described in the Shareholder Letter, it is clear that Foreign Subsidiary is a part of this network that develops, manufactures, markets, distributes and services [REDACTED] Foreign Subsidiary is integrated with Parent and other operational companies at the basic operational level.

Water's Edge Provision

Taxpayer argues that Foreign Subsidiary cannot be included in the combination because it is not a domestic corporation. Taxpayer argues that the Arizona statute expressly provides for a true water's edge unitary combination in which the "net income of a foreign corporation which is not itself subject to the tax imposed by this title shall not be allocated or apportioned to this state." A.R.S. §43-1132.A.

The Division is not attempting to include the net income of a foreign subsidiary, which is what is addressed by A.R.S. §43-1132.A. A determination that a subsidiary is part of the unitary group is not the same as a determination that its net income should be allocated or apportioned. The latter is not at issue in this case. It is the income from a domestic subsidiary, Holding Company, which is at issue. A foreign subsidiary can be a part of the unitary group but its income is not allocable or apportionable to Arizona because of Arizona's water's edge statute.

Passive Holding Company

The gain the Division seeks to include in Taxpayer's apportionable income is Holding Company's gain. Taxpayer argues that Holding Company cannot be integrated at the basic operationally level because it is a holding company and, as such, it does not engage in the activities described. Referring to the administrative rule addressing unitary combinations for manufacturing businesses, A.A.C. R15-2-1131.E.1, Taxpayer argues that the Division has not pointed to any transfer of material, products, goods, technological data and processes, or machinery and equipment between Parent and Holding Company and

that there cannot be such a transfer because the latter merely holds stock. Taxpayer claims the gain made on the sale of stock held by Holding Company was solely a function of the [REDACTED] stock market.

There is one very substantial transfer between Holding and Parent. A significant portion of the proceeds from the sales of stock of Foreign Subsidiary was loaned by Holding Company to Parent and was used by Parent to buy back Parent's common stock listed on the NASDAQ in the United States. However, as a holding company, the transfers mentioned in the rule are not present.

Holding Company is an intermediary passive holding company, owned by an operating parent company and owning a controlling share of another operating company. As discussed above, the two operating companies are unitary. Holding Company's primary function is to hold an operating company for the benefit of Parent. "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." A.A.C. R12-2-1131.E. Given that Foreign Subsidiary is a part of a unitary group, it cannot be supposed that the value of its stock came solely from the activities of Foreign Subsidiary. The interdependence of the operational companies making up the unitary group, which includes Foreign Subsidiary, makes it impossible to determine where the value of the stock arose.

Holding Company is performing a unitary function for the group by holding (and selling) the stock of the lower tier operating company which would be a unitary business asset of Parent if it were held by Parent directly. It dedicates all or virtually all of its activity, however small, to the parent and subsidiary, including selling the stock of the latter to loan its proceeds to the former. It is an integral part of a larger, unitary system. To separate the Holding Company for combined reporting purposes places too much emphasis on the form of corporate structure, when the substance is that Holding Company and the two operating companies, Parent and Foreign Subsidiary, are engaged in one unitary business. Holding Company is a part of the unitary group.

Imputing Activities

Finally, Taxpayer argues that the Department cannot impute to Holding Company the activities of Foreign Subsidiary to establish that the former is integrated at the basic operational level because the Department has taken the position that a holding company's operations are not the same as the company it holds. Taxpayer claims that the position taken by the Division in this case contradicts the Department's official policy regarding holding companies, as set forth in the answer brief and the unpublished Court of Appeals decision in the case of *Phoenix Newspapers et al* v. *Arizona Dep't of Revenue*, 1 CA-TX 04-0014 (Ariz. Ct. App. Dec. 6, 2005). Taxpayer characterizes the position taken by the Department in that case as "business operations of an entity that is owned by a holding company may not be imputed to the holding company to conclude that the holding company is operationally integrated with the unitary group."

In *Phoenix Newspapers*, the taxpayer sought to combine two out-of-state holding companies, Central Newsprint and Bradley Paper, with Phoenix Newspapers, Inc. The same parent company owned Phoenix Newspapers and Central Newsprint. Central Newsprint owned Bradley Paper. Newspaper publishers, including the parent company, formed a partnership, Ponderay Newsprint Co. (Ponderay) to build and run a newsprint mill in Washington. The parent used the two holding companies to hold its interest in Ponderay. Together the two holding companies owned less than fifteen percent interest in Ponderay, which was managed by another partner which held a forty percent interest in the partnership. Phoenix Newspapers purchased newsprint from the Ponderay at an arm's-length price. In this context the Department denied the combination of Phoenix Newspapers and the two holding companies.

At the Court of Appeals the Department argued that the two holding companies did not conduct or control Ponderay and that the business activity of a holding company was not identical to the business activity of its underlying entity. The taxpayer argued to "look through" the holding companies to the operational company to determine the business activity of the holding companies. The taxpayer wanted to treat the holding companies as if they were identical to Ponderay and treat all sales by Ponderay as if they were sales by the holding company. The Department argued that the partnership's business activities are not identical to those of its partners, citing *Devenir Assocs*. v. *City of Phoenix*, 164 Ariz. 530,

532, 794 P. 2d 605, 607 (Tax 1990) (holding that the partnership engaged in the business of leasing real property even though its partners engaged in the business of practicing law).

First, *Phoenix Newspapers* is distinguishable from the current case. The holding companies in *Phoenix Newspapers* did not have a controlling interest in Ponderay while Holding Company does. In addition, in *Phoenix Newspapers* the taxpayer tried to combine sibling corporations and not the parent company. In this case Taxpayer includes Parent Company.

Second, what is being argued in this case is not a "look through" as was argued in *Phoenix Newspapers*. Holding Company does not take on the business of Foreign Subsidiary. As stated above, Holding Company is participating in the unitary business by holding a controlling interest in Foreign Subsidiary, a lower tier operating company, which would be a unitary business asset of Parent if it were held by Parent directly.

Taxpayer determined Holding Company was a part of the unitary group when it filed its original returns. The Hearing Officer held Holding Company was a part of the group.

Business/Nonbusiness Income

Taxpayer argues that even if Holding Company is a part of the unitary combination, Holding Company's gains from its sales of Foreign Subsidiary stock constitute nonbusiness income. The Division argues the sale of Foreign Subsidiary stock is business income. A.A.C. R15-2-1131.A provides that "[f]or purposes of administration, the income of the taxpayer is business income unless clearly classified as non-business income."

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. Taxpayer argues that the gain from the sale of Foreign Subsidiary stock is nonbusiness income and is not allocated to Arizona; therefore, it should not be taxed by Arizona. 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. § 43-1131.1 defines "business income" as:

> . . . 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 "non-business income" to mean all income other than business income. A.A.C. R15-2-1131.A provides in pertinent part:

> 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.
>
> "Non-business income" means all income other than business income.

A.R.S. § 43-1131.1 and A.A.C. R15-2-1131 provide 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. R15-2-1131.B.1.b 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." This is a functional test.

Taxpayer disputes that Arizona has a functional test. Arizona Corporate Tax Ruling CTR 94-3 provides, in part:

> The definition of business income contained in A.R.S. § 43-1131.1 provides two alternative tests to determine whether income constitutes business income. The first test contained in the definition of business income 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* which provides that 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."

Furthermore, Arizona Corporate Tax Ruling CTR 94-12 also 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. A.R.S. § 43-947.F provides that an affiliated group shall allocate and apportion its income to this state in the manner prescribed in sections 43-1131 et. seq. While CTR 94-12 is discussing business and non-business income in the context of an affiliated group rather than a unitary group, the statutes are the same for both. 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). Arizona has a functional test.

The origins of the language of the definition of "business income" supports the conclusion there is a functional test. The first draft of UDITPA did not distinguish between business and nonbusiness income. After concerns about the constitutionality of the first draft arose, a definition of business income was added. The definition was based on the language used in certain California State Board of Equalization decisions. Those decisions consistently applied an independent functional test, using virtually identical language to the second clause of the UDITPA definition. *Hoechst Celanese Corp.* v. *Franchise Tax Bd*, 22 P.3D 324, 330 – 336 (Cal. 2001). Arizona's statutory language for the definition of business income parallels the UDIPA language. Arizona has an independent functional test.

As previously noted, A.A.C. R15-2-1131.B.1.b 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. That rule provides that the gains or losses from sales of assets, whether 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. The purpose of Holding Company was to hold and sell the common stock of Foreign Subsidiary. Foreign Subsidiary stock was used in Taxpayer's business to control Foreign Subsidiary so it would provide a part of Taxpayer's global market place. Therefore, pursuant to A.R.S. § 43-1131.1 and A.A.C. R15-2-1131, Holding Company's gains from sales of the common stock it owned in Foreign Subsidiary is apportionable business income under the functional test.

Taxpayer argues that the determination of business income requires a transaction-specific analysis even if there is a functional test. Taxpayer appears to be taking the position that both the transactional and functional tests must be met. Further, Taxpayer maintains that the position taken by the Division is inconsistent with Arizona Corporate Tax Ruling, CTR 00-1.

Arizona Corporate Tax Ruling, CTR 00-1, addresses treatment of gains and losses on the sale of stock. Relying on *Allied Signal* v. *New Jersey*, 112 S. Ct. 2251 (1992), *F.W. Woolworth Co.* v. *Taxation and Revenue Dept. of New Mexico*, 102 S. Ct. 312 (1982); *Asarco, Inc*. v. *Idaho State Tax Commissioner*, 102 S. Ct. 3103 (1982), *General Motors* v. *Arizona Dept. of Revenue*, 189 Ariz. 86, 938 P. 2d 481 (1996), the Ruling states that the sale of stock of a unitary subsidiary is considered earned in the regular course of a trade or business of the taxpayer and is business income, whether the stock sold is in foreign corporations or in domestic corporations. Further, the Ruling states that gain on the sale of stock of a non-unitary company is considered business income when the investment in stock serves an operational purpose as opposed to a passive investment purpose.

Applying the Ruling, Foreign Subsidiary is a unitary subsidiary, therefore, the sale of its stock is business income. Even if Foreign Subsidiary was not a unitary subsidiary, the sale of its stock would be business income if the investment (owning stock in Foreign Subsidiary) serves the operational purpose. As discussed above, a part of Parent's business plan was to have a global market, to be able to provide its customers products and service in all nations and all languages. Providing Parent's products to the

[REDACTED] market serves an operational function, therefore, holding a controlling ownership of the company that does this serves an operational purpose. The position taken by the Division is consistent with CTR 00-1.

An agency's long-standing position will be given great weight. *Marlar v. State*, supra. CTR 001 provides that the sale of stock of a unitary subsidiary is business income, whether a foreign or domestic subsidiary. The stock in Foreign Subsidiary meets this test. The gain from the sale of Foreign Subsidiary stock is business income.

Constitutional Challenge

The United States Supreme Court has held that a taxing authority's apportionment formula 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). The taxpayer has the burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed. *Container Corporation of America* v. *Franchise Tax Board*, 103 S. Ct. 2933, 2940 (1943).

Taxpayer argues that the Department's attempt to treat the gain as apportionable business income is unconstitutional in that it violates the fourth prong of the test set forth by the United States Supreme Court in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). In *Brady,* the United States Supreme Court observed that a state tax is constitutionally valid if the tax satisfies the following four-prong test: 1) it is applied to an activity with a substantial nexus with the taxing state, 2) it is fairly apportioned, 3) it does not discriminate against interstate commerce and 4) it is fairly related to the services provided by the state.

Under the *Complete Auto Transit* test, "when the measure of a tax bears no relationship to the taxpayer's presence or activities in a State, a court may properly conclude under the Fourth Prong of the *Complete Auto Transit* test that the State is imposing an undue burden on interstate commerce." *Commonwealth Edison Co*. v.

Montana, 453 U.S. 609, 629 (1981). Taxpayer maintains that the gain from the sale of the stock in Foreign Subsidiary does not fairly relate to the services provided by the state for several reasons. Taxpayer makes several arguments in support of this position.

First, Taxpayer states that Foreign Subsidiary operated independently from Parent and Parent did not contribute to or participate in the marketing of Foreign Subsidiary's [REDACTED]. Furthermore, Taxpayer argues that Foreign Subsidiary created its own [REDACTED] without participation from Parent. In the Shareholder Letter, the [REDACTED] explained how its companies in various areas of the world had voluntarily participated in common computer, database and marketing systems which were offered to them by Parent without extra charge, thus creating global networks. This is not operating independently. Furthermore, as to the [REDACTED], as discussed above, it is Parent's [REDACTED] that is adapted by Foreign Subsidiary and there is no indication that Foreign Subsidiary sells any products not based on Parent's technology. This makes Foreign Subsidiary totally dependent on Parent for its products.

Second, Taxpayer states that the gain in the stock in Foreign Subsidiary is largely attributable to an overheated [REDACTED] stock market. Taxpayer has not offered evidence of an overheated [REDACTED] stock market. Nor has Taxpayer offered evidence that all the gain is attributable to that condition.

Third, Taxpayer argues that the gain is unrelated to the activity in Arizona. The activity in Arizona included marketing, sales and consulting of Parent's [REDACTED] products, while Foreign Subsidiary hired its own personnel to do significant modification of Parent's [REDACTED] and then did its own marketing. Once again this completely ignores the description of the global network of which Arizona and Foreign Subsidiary were all a part. Both places did marketing, sales and consulting using the global networks. Even if Arizona had no direct part in modifications of [REDACTED], there was considerable overlap in the activities and the underlying products were the same as Foreign Subsidiary used.

Finally, Taxpayer argues that the level of activity in Arizona, as measured by the in-state gross revenue, did not materially change during 1998 to 2001, however the Division seeks to increase the income attributable to Arizona substantially, approximately

$[REDACTED] for 1999 and approximately $[REDACTED] for 2000. These are not the amounts being attributed to Arizona, only the apportioned amounts are attributed to Arizona. An increase in apportionable income increases apportioned amounts to all members of a unitary group. If a large increase in apportioned income was a measure for whether or not it was related to the activity in Arizona, the sale by a unitary subsidiary of a substantial amount of business assets in Arizona would never be apportionable. Taxpayer argues that the activities in Arizona are different than those in [REDACTED]. This ignores the facts presented in the Shareholder letter. The letter shows that products sold by Arizona and Foreign Subsidiary were Parent's products, albeit that they had been modified for the [REDACTED] market. Both Arizona and [REDACTED] were a part of the global network of sales and services.

None of Taxpayer's arguments provide support for its position that the Fourth Prong is violated by including the stock sale gains in apportionable income. Taxpayer failed to show that the Division's application of Arizona's allocation and apportionment provisions does not fairly represent the extent of Taxpayer's business activity in Arizona or that it produces incongruous results. Taxpayer has failed to prove that the income attributed to Arizona has led to a grossly distorted result or is in fact out of all appropriate proportion to the business transacted in Arizona.

Further, as the Hearing Officer observed, in *Container Corporation of America v. Franchise Tax Board,* 103 S.Ct. 2933, 2940 (1983), the United States Supreme Court addressed apportioning among states income of a unitary business, which is more on point than is *Brady* in the present case. There the Supreme Court declared that "the linchpin of apportionability in the field of state income taxation is the unitary business principle." The 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 . . . It also requires that there be some bond of ownership or control uniting the "unitary business." . . .
>
> In addition, the principles we have quoted require that the out-of-State activities of the purported "unitary business" be related in some concrete way to the in-State activities. The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or measurement- beyond the mere flow of funds arising out of a passive investment or a distinct business operation- which renders formula apportionment a reasonable method of taxation. (Citations omitted.)

A.A.C. R15-2-1131.E.1 accordingly provides in part that "[a]t least some part of the unitary business must be conducted in Arizona."

It is undisputed that at least a part of Taxpayer's unitary business was conducted in Arizona during the audit period and that there was some bond of ownership or control between the entities included in the assessment. In *Container Corporation* the Court pointed out the taxpayer has the burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed. The Hearing Officer found that Taxpayer provided insufficient evidence to prove that extraterritorial values are being taxed by Arizona in this instance. No evidence has been presented which would require that conclusion to be overturned.

Subsequent to the appeal of the current case, the United States Supreme Court once again addressed the constitutional scope of the unitary business for purposes of state apportionment of corporate income tax. *Meadwestvaco Corp.* v. *Illinois Department of Revenue*, 128 S.Ct. 1498 (2008). This is the latest pronouncement in a string of cases beginning in 1980 with *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), including *Container Corporation*, supra, and, most recently, including *Allied-Signal, Inc*. v. *Director, Division of Taxation*, 504 U.S. 768 (1992).

In *Meadwestvaco Corp*. the Court once again reiterated that the "hallmarks" of a unitary relationship are functional integration, centralization of management and economies of scale. While Taxpayer argues otherwise, the Court discussed the operational-function test as a secondary way of determining a unitary relationship:

> As the foregoing history confirms, our references to 'operational function in *Container Corp.* and *Allied Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.'

Meadwestvaco Corp., 128 S.Ct. 1507 – 1508. After discussing the examples of operational assets given in *Allied Signal, supra,* (the taxpayer was not unitary with its banker, but the taxpayer's deposits were working capital, thus operational assets and were clearly unitary with the taxpayer's business) and *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46, 50, 76 S.Ct. 20, 100 L.Ed. 29 (1955) (concluding that corn futures contracts in the hands of a corn refiner seeking to hedge itself against increases in corn prices are operational rather than capital assets), the Court stated:

> The conclusion that the asset served an operational function was merely instrumental to the constitutionally relevant conclusion that the asset was a unitary part of the business being conducted in the taxing State rather than a discrete asset to which the State had no claim.

Even if Foreign Subsidiary and Holding Company were not unitary with Parent in the enterprise sense, as discussed in the Unitary Combination section above, controlling ownership in Foreign Subsidiary constitutes an operational function or purpose for the unitary group. Therefore, the stock in Foreign Subsidiary would be a unitary asset of Parent and the gain or loss from its sale may be taxed as a part of the apportionable income as would any other income of the combined group.

Taxpayer has not shown that the assessment of the gain from the sale of Foreign Subsidiary stock as apportionable income violates the United States Constitution.

The assessment is proper.

O R D E R

The Hearing Officer's decision is affirmed.

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 8th day of September, 2008.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the
foregoing mailed to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

GG:st

cc: Corporate Income Tax Appeals Section
Corporate Income Tax Audit Section
Audit Division