

(Redactor's Note: The 3 references below to IRC § 331(h)(10) contain a typographical error and should refer to IRC § 338(h)(10).)

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)	DECISION OF
)	HEARING OFFICER
[REDACTED])	
and SUBSIDIARIES)	
)	Case No. 200800128-C
FEIN [REDACTED])	
_____)	

A hearing was held on February 24, 2009 in the matter of the protest of [REDACTED] and Subsidiaries (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 December 31, 1999 through December 31, 2002 (Audit Period). Taxpayer's opening post-hearing memorandum was timely filed under extension on April 10, 2009. The Section's response post-hearing memorandum was timely filed on May 11, 2009. Taxpayer's reply post-hearing memorandum was timely filed under extension on June 2, 2009. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

The parties' joint listing of facts establishes the following. Taxpayer is incorporated in [REDACTED] and its commercial domicile in 1999 was located in [REDACTED]. While providing general [REDACTED] services to its customers, Taxpayer operated three principle business segments: [REDACTED], [REDACTED], and [REDACTED].

In 1999, Taxpayer filed a combined Arizona income tax return. The combined return included one of its subsidiaries, [REDACTED] ([SUBSIDIARY]). [SUBSIDIARY] provided a variety of back-office processing services to the [REDACTED].

In 1999, Taxpayer sold all of its stock in [SUBSIDIARY] to [REDACTED] for cash proceeds of approximately \$[REDACTED]. Taxpayer and [REDACTED] elected to treat the sale of [SUBSIDIARY] as an asset sale under Internal Revenue Code (IRC) § 338(h)(10). Prior to the sale, Taxpayer reported the income produced by [SUBSIDIARY] as business income on their 1999 combined Arizona income tax return. However, Taxpayer treated the gain from the § 338(h)(10) sale of [SUBSIDIARY] as non-business income on its 1999 Arizona corporate income tax return.

The Section subsequently audited Taxpayer's Arizona income tax returns from 1999 to 2002. Among other things, the Section determined that Taxpayer's gain in 1999 from the § 338(h)(10) sale of [SUBSIDIARY] should have been treated as business income. As a result of the audit, on June 27, 2007, the Section issued a Notice of Proposed Assessment (the "Assessment") for the Audit Period, assessing income tax in the amount of \$[REDACTED] and interest of [REDACTED] (accrued through July 15, 2007). No penalties were imposed.

Taxpayer timely protested the Assessment and a hearing on the matter was later requested on three main issues: 1) the business/non-business treatment of a § 331(h)(10) election, 2) inclusion of sales from a [REDACTED] business in the numerator of the sales factor, and 3) whether or not certain sales of

[REDACTED] assets should be included at net in the denominator of the sales factor. However, at the hearing, the parties stated that they were in the process of negotiating an agreement on all remaining issues other than the business/non-business treatment of Taxpayer's gain from the sale under the IRC § 331(h)(10) election.

On or about April 24, 2009, the parties entered into a partial closing agreement ("Closing Agreement") regarding the Assessment for the Audit Period. The Closing Agreement resolved the issues pertaining to the Assessment except for the business/non-business treatment of Taxpayer's sale of [SUBSIDIARY]. Therefore, the only remaining issue is whether Taxpayer's gain from the sale of [SUBSIDIARY], wherein Taxpayer and the buyer made an election under IRC § 331(h)(10) to treat such sale as a sale of all of its assets, should be treated as business income or non-business income.

At the hearing, and in its memorandum, the Section maintains that under the functional test for determining whether an item is business or non-business income, Taxpayer's gain constitutes business income. Taxpayer asserts that any such gain should be treated as non-business income to the Taxpayer. Taxpayer also asserts 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

At issue is whether the sale of [SUBSIDIARY] 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." This suggests that Arizona has clearly adopted both the "transactional test" and the "functional test."¹

As noted above, 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. Prior to its amendment in 2001,² the functional test set forth in A.A.C. R15-2D-503 provided, in part, as follows:

[G]ain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes

¹ Also see Arizona Corporate Tax Ruling CTR 94-12 which discusses both a transactional and functional test in determining what is business and non-business income for an Arizona affiliated group that files an Arizona consolidated income tax return.

² The language of the current rule is substantially the same.

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 the sale at issue here, we first look at [SUBSIDIARY] itself. Taxpayer filed a combined Arizona income tax return in 1999. [SUBSIDIARY] was included in Taxpayer's 1999 combined return. In addition, Taxpayer reported the income produced by [SUBSIDIARY] (prior to its sale) as business income on the 1999 combined return. Because the property sold was used in Taxpayer's business prior to the sale (and the associated income was reported as business income), under Arizona's administrative rules, the gain from the sale would be treated as business income.

In addition to the administrative rules, the Department has issued tax rulings that are relevant to the matter at issue. Tax rulings issued by the Department are public written statements of the Department's position interpreting Arizona tax law and apply the law to a specific set of facts or a general category of taxpayers. See Arizona General Tax Ruling (GTR) 08-1. Rulings are issued when the Department determines that they are necessary or helpful in effective tax administration, usually where a problem affects a large number of taxpayers or is recurring. Corporate Tax Ruling (CTR) 00-1 addresses whether gain or loss on a sale of stock is business or non-business income. Its Ruling

section provides that “[g]ain on 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.” CTR 00-1.

In this case, Taxpayer sold its stock in [SUBSIDIARY], a unitary subsidiary that was part of Taxpayer’s combined group in 1999. Therefore, under CTR 00-1, the gain from such sale is considered business income.

Taxpayer asserts that even if a “functional test” exists, the gain from a sale which the parties have made an IRC § 338(h)(10) election does not constitute business income. In an IRC § 338(h)(10) election, the target corporation (in this case, [SUBSIDIARY]) is deemed to have sold all of its assets and then distributed the proceeds to the parent corporation in complete liquidation. Taxpayer cites cases from a number of states³ that have applied a so-called “liquidation exception” to the functional test. As pointed out in the parties’ memoranda, the “liquidation exception” generally provides that the disposition of all of a company’s assets in liquidation cannot constitute an integral part of a taxpayer’s regular trade or business. Therefore, the gain from such a transaction cannot be considered “business income.” The states are not uniform in the allowance

³ Among the cases listed in Taxpayer’s memoranda that allowed a “liquidation exception” were: *Lenox v. Tolson*, 548 S.E.2d 513 (N.C. 2001); *Blessing/White, Inc. v. Zehnder*, 768 N.E.2d 332 (App. Ct. Ill. 2002); *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489 (Ct. App. 1975); and *Canteen Corp. v. Commonwealth of Pennsylvania*, 818 A.2d 594 (Pa. Comm. Ct. 2003).

of a "liquidation exception."⁴ In addition, the Arizona courts have not addressed this issue, and have never adopted a "liquidation exception" to the functional test.

However, an Arizona Corporate Tax Ruling has specifically addressed the issue of whether gain from a sale pursuant to IRC § 338(h)(10) is considered business income. CTR 98-2 provides, in part, as follows:

8. Is the target's gain resulting from an IRC § 338(h)(10) election considered business income subject to apportionment or nonbusiness income allocable to a particular state?

The gain from the deemed sale of the target's assets is usually treated as business income subject to apportionment.

Thus, pursuant to CTR 98-2, even where a taxpayer has entered into a sale of stock under an IRC § 338(h)(10) election, the gain is to be treated as business income in Arizona. Nothing in the rule or any other Arizona law provides for a "liquidation exception" where an IRC § 338(h)(10) election is made.

As shown above, Arizona Administrative Rules and Tax Rulings issued by the Department interpret the definition of "business income," as found in A.R.S. § 43-1131(1), to include the gain from the sale of Taxpayer's unitary subsidiary's stock, even where Taxpayer has made an IRC § 338(h)(10) election. Although courts are "not bound by an agency's interpretation of a statute

⁴ For instance, California, whose statutory definition of "business income" is the same as that found in A.R.S. § 43-1131(1), refused to accept a "liquidation exception" to the functional test. See *Jim Beam Brands Co. v. California Franchise Tax Bd.*, 34 Cal. Rptr. 3d 874 (2005).

that it enforces, absent contrary legislative intent," courts will "generally give an agency's construction 'great weight.'" *Davis v. Arizona Dep't of Revenue*, 197 Ariz. 527, 530, 4 P.3d 1070, 1073 (App. 2000).

Citing *Ariz. State Bd. Of Regents ex rel. Ariz. State Univ. v. Ariz. State Pers. Bd.*, 195 Ariz. 173, 175 985 P.2d 1032, 1034 (1999), Taxpayer asserts that where an agency's policies or rules are in conflict with the plain language of a statute such rules cannot be upheld. However, Taxpayer has not established that the Department's rulings are in conflict with the language contained in A.R.S. § 43-1131(1).

Moreover, Arizona law makes it clear that "the construction that an agency places on a statute it administers, if acquiesced in for a long period of time, will not be disturbed unless *manifestly erroneous*." *Arizona Dep't of Revenue v. Raby*, 204 Ariz. 509, 512, 65 P.3d 458, 461 (App. 2003)(emphasis added). The Department's interpretations have been in place since the Audit Period, and the Arizona Legislature has not altered the language of the definition in its statutes to correct such interpretations.

Nor is the Department's interpretation "manifestly erroneous." Indeed, the Department's interpretations found in the Arizona Administrative Rules and Tax Rulings are in harmony with the California Court of Appeals. See *Jim Beam Brands Co. v. California Franchise Tax Bd.*, 34 Cal. Rptr. 3d 874 (2005) (holding that a company's gain from the sale of its subsidiary's stock under an IRC § 338(h)(10) election constituted business

income under the functional test). The Department's interpretations are also consistent with the proposed regulations approved by the Multistate Tax Commission which provide that income "derived from . . . transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations." MTC Reg. IV.1.(a)(5)(B).

The Section's determination in this matter was in accordance with the Arizona Administrative Rules and Tax Rulings. Taxpayer has not shown that these regulations and rulings are manifestly erroneous. Therefore, the Hearing Office upholds that portion of the Assessment concluding that Taxpayer's gain from the sale of [SUBSIDIARY] under an IRC § 338(h)(10) election is to be treated as business income.

Based on the foregoing, Taxpayer's protest of the items not agreed to by the parties in the Closing Agreement is denied.

DATED this 10th day of July, 2009.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[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 Appeals Section