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Governor

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Director

## TAXPAYER INFORMATION RULING LR10-008

March 24, 2009

The Department issues this taxpayer information ruling in response to your letter of August 24, 2009, requesting a ruling on behalf of an undisclosed taxpayer. Specifically, you request the Department rule intercompany amounts should be eliminated from the sales factor in the proposed transactions detailed below.

### **Background:**

The following background is based on the written materials and illustrative exhibits provided by the taxpayer. The materials and exhibits you provided in your letter detail the relevant legal entities and the structure of the taxpayer's consolidated group. **(See attached Exhibits 1-3)**

PARENT is a holding company with numerous affiliated entities that have elected to file an Arizona consolidated return.

A CORP is a subsidiary corporation which markets products made by its subsidiary C CORP in Arizona.

B CORP is a subsidiary corporation which makes products in Nevada, and is 100% owned by A CORP.

E SMLLC, a disregarded entity for federal income tax purposes, provides material and labor exclusively for the use by C CORP's operations and is owned 100% by D LLC.

D LLC is a partnership for federal income tax purposes and is owned 50% by B Corp and 50% by INDIVIDUAL.

INDIVIDUAL is a person who is not related to PARENT or any of its affiliates.

### **Statement of Facts:**

The following statement of facts is based on the written materials and illustrative exhibits provided by the taxpayer. The materials and exhibits you provided in your letter detail the proposed transactions the taxpayer's consolidated group intends to make. **(See attached Exhibits 1-3)**

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INDIVIDUAL and B CORP have formed a joint venture, D LLC. Fifty percent of D LLC is owned by B CORP and the other fifty percent by INDIVIDUAL.

D LLC, through its disregarded entity, E SMLLC, provides goods and services exclusively for use in C CORP's operations in Arizona.

In a proposed transaction, INDIVIDUAL, will sell his interest in D LLC. After the transaction D LLC will be wholly owned by the PARENT Arizona affiliated group. D LLC through its disregarded entity, E SMLLC, will continue to sell 100% of its product and provide services to C CORP via an intercompany sale/service agreement.

In addition, the PARENT Arizona affiliated group owns 100% of F LLC that operates exclusively outside of Arizona, providing personnel services to A CORP via an intercompany service agreement. All sales by F LLC are to A CORP.

Taxpayer represents the partnership income is distributed to the affiliated group from D LLC (via its disregarded entity – E SMLLC) and from F LLC is business income to the Arizona affiliated group.<sup>1</sup>

### **Questions Presented by Taxpayer:**

1. Prior to the proposed transaction, should sales between D LLC (via its disregarded entity) and a member of the PARENT Arizona affiliated group, be treated as an intercompany elimination in the Arizona consolidated return? **(See Exhibit 1)**
2. After the proposed transaction, should sales between D LLC (via its disregarded entity) and a member of the PARENT Arizona affiliated group, be treated as an intercompany elimination in the Arizona consolidated return? **(See Exhibit 2)**
3. Should the sales between F LLC and A CORP be treated as an intercompany elimination in the Arizona consolidated return? **(See Exhibit 3)**

### **Applicable Law:**

Arizona Revised Statutes (A.R.S.) § 43-1131(1) and Arizona Administrative Code (A.A.C.) R15-2-1131(A) define "business income" to mean income arising from transactions and activity in the regular course of taxpayer's trade or business.

A.R.S. § 43-1139 provides that all business income shall be apportioned to Arizona by use of a three-factor formula consisting of property, payroll, and sales factors.

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<sup>1</sup> This ruling does not make any determination regarding the accuracy of this representation.

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A.R.S. § 43-1145 provides the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

A.R.S. § 43-947(D) provides an affiliated group may file a consolidated return to this state only if the affiliated group properly elected or was required to file a consolidated federal return under section 1501 of the internal revenue code.

A.R.S. § 43-947(F) provides the affiliated group shall allocate and apportion its income to this state in the manner prescribed in chapter 11, article 4 of Title 43. For the purposes of allocation and apportionment of income, the Arizona affiliated group is considered to be and shall be treated as a single taxpayer.

A.R.S. § 43-947(I)(1) defines “affiliated group” as the corporations that have properly elected or are required to file consolidated federal income tax returns under section 1501 of the internal revenue code.

A.R.S. § 43-947(I)(1) defines “Arizona affiliated group” as the corporations for which a proper election to file a consolidated return under this section has been made or the corporations that are required to file a consolidated return under subsection C.

A.A.C. R15-2D-405 provides that 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.

Arizona Corporate Tax Ruling (CTR) 94-2 provides that if a corporate partner’s distributive share of its partnership income is business income, then its proportionate share of the partnership’s property, payroll, and sales should be included in the appropriate factors in determining the apportionment ratio of the corporate partner.

### **Taxpayer Position:**

1. Intercompany receipts between D LLC and C CORP should be eliminated from the numerator and denominator of the Arizona consolidated receipts factors when Taxpayer owns 50% of D LLC.
2. Intercompany receipts between D LLC and C CORP should be eliminated from the numerator and denominator of the Arizona consolidated receipts factor when Taxpayer wholly owns D LLC.
3. The intercompany receipts between A CORP and F LLC should be eliminated from the numerator and denominator of the Arizona consolidated receipts factor, when all

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of F LLC's activity takes place outside of Arizona and it is wholly owned by the PARENT Arizona affiliated group.

### **Discussion:**

Taxpayer has asked various questions regarding the treatment of sales made by a business partnership to its corporate parent or members of the parent's Arizona affiliated group when determining the Arizona affiliated group's sales factor for purposes of apportioning business income to Arizona.

The net income of a partnership flows-through proportionately to all the partners and is included in the tax return of the partners. All business income is apportioned to Arizona using a three-factor formula consisting of property, payroll and sales factors. Taxpayer has stated the incomes from the partnerships in question are business income to the corporate parent. Therefore, the business partnership income that flows-through to the Arizona affiliated group must be given factor representation in the apportionment ratio of the Arizona affiliated group.

Factor representation for a corporate partner's distributive share of its business income from a partnership is provided by including a proportionate share of the partnership's property, payroll, and sales in the appropriate factors of the corporate partner (see CTR 94-2). For example, a corporate partner whose distributive share of a business partnership is fifty percent would include fifty percent of the partnership's sales from everywhere in the denominator of the corporation's sales factor and fifty percent of the partnership's Arizona sales in the numerator of the corporation's sales factor. The corporation's proportionate share of the partnership's sales would then be considered to be the corporation's sales.

An Arizona affiliated group is made up of the members of a federal consolidated return that have made a valid election to file the same group to Arizona in an Arizona consolidated return. Pursuant to A.R.S. § 43-947(F) an Arizona affiliated group is considered to be and shall be treated as a single taxpayer for purposes of apportionment. A.A.C. R15-2D-405 provides that members of a combined or consolidated return shall eliminate intercompany amounts included in the group's apportionment factors when necessary to avoid distortion of the group's Arizona taxable income.

Taxpayer has stated that all of the partnership's sales are to members of its Arizona affiliated group. If all of a partnership's sales are to the corporate parent or other members of its Arizona affiliated group, then all of the sales that flow through from the partnership to the corporation's sales factor are considered intercompany sales.

Intercompany sales between members of the Arizona affiliated group essentially create fictitious income for the Arizona affiliated group. For example, assume the first member of the Arizona affiliated group incurs expenses and then makes a sale to the second member

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of the Arizona affiliated group that records the purchase. When looking at the affiliated group as one taxpayer, the sale price income recognized by the first member and purchase price expense recognized by the second member should offset leaving only the expenses incurred by the first member of the group. Including the sales of the first member overstates the sales of the group as a whole. Unless the intercompany sales are inconsequential, their elimination from the Arizona affiliated group's sales factor will be considered necessary to avoid distortion of the group's Arizona taxable income.

### **Conclusion and Ruling:**

1. Prior to the proposed transaction, should sales between D LLC (via its disregarded entity – E SMLLC) and a member of the PARENT Arizona affiliated group, be treated as an intercompany elimination in the Arizona consolidated return?

One hundred percent (100%) of the sales of D LLC are to the affiliated group and fifty percent (50%) flows-through to the Arizona affiliated group's return. Therefore, in order to avoid distortion of the affiliated group's Arizona taxable income the portion of D LLC's sales included in the calculation of the affiliated group's apportionment ratio should be eliminated from the numerator and denominator of the sales factor on the consolidated return.

2. After the proposed transaction, should sales between D LLC (via its disregarded entity – E SMLLC) and a member of the PARENT Arizona affiliated group be treated as an intercompany elimination in the Arizona consolidated return?

One hundred percent (100%) of D LLC's sales are included in the Arizona affiliated group's sales factor. Therefore, in order to avoid distortion of the affiliated group's Arizona taxable income all of D LLC's sales included in the calculation of the Arizona affiliated group's apportionment ratio should be eliminated from the numerator and denominator of the sales factor on the consolidated return.

3. Should the sales between F LLC and A CORP be treated as an intercompany elimination in the Arizona consolidated return?

One hundred percent (100%) of F LLC's sales are included in the Arizona affiliated group's sales factor. Therefore, in order to avoid distortion of the Arizona affiliated group's Arizona taxable income all of F LLC's sales included in the calculation of the Arizona affiliated group's apportionment ratio should be eliminated from the numerator and denominator of the sales factor on the consolidated return.

This taxpayer information ruling does not extend beyond the facts presented in your letter and enclosed documents of August 24, 2009.

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**This response is a taxpayer information ruling (TIR) and the determination herein is based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer information ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law, or notification of a different Department position.**

**If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.**

Exhibit 1

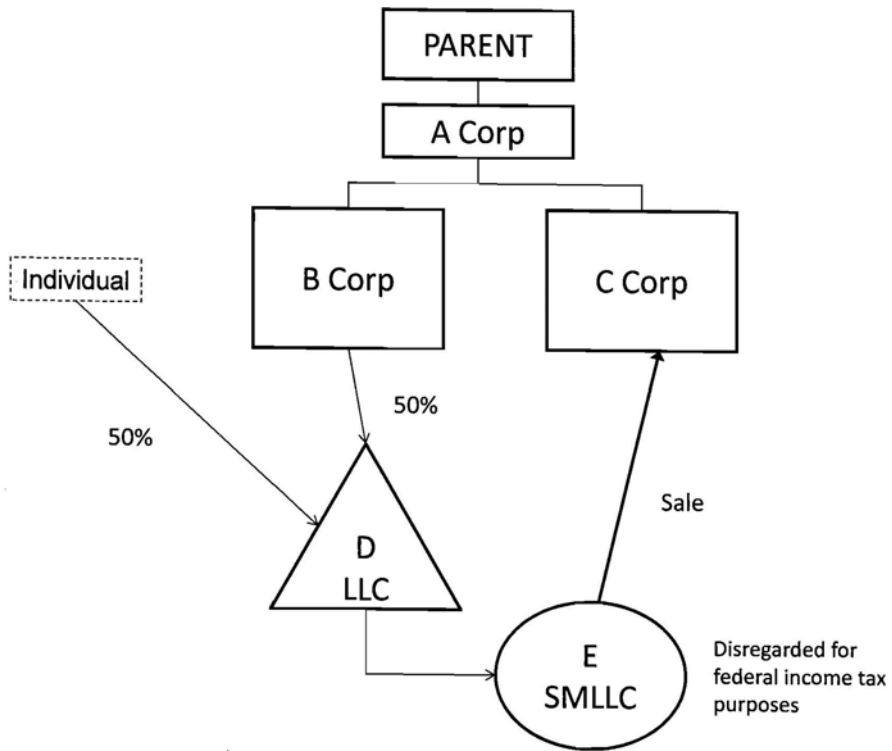
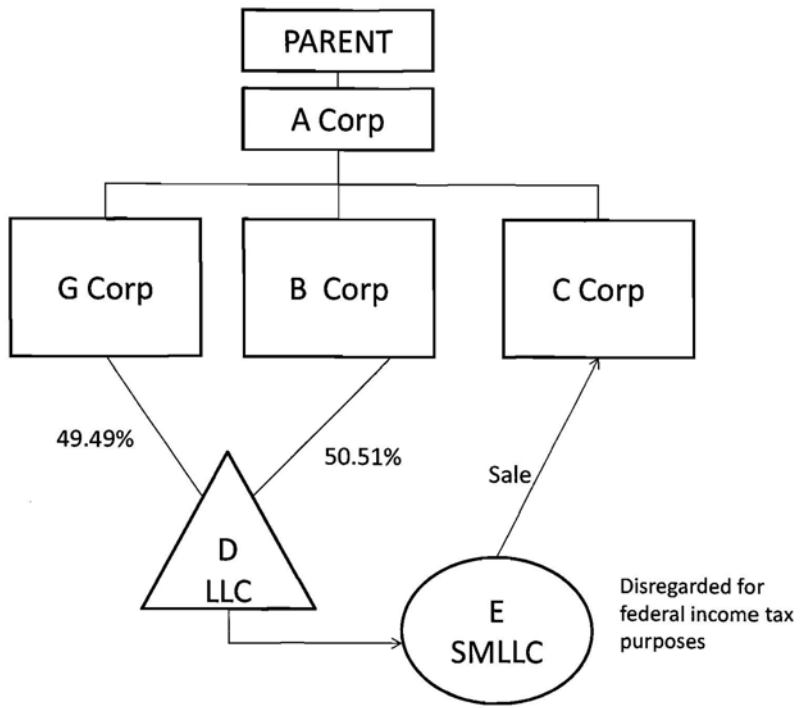


Exhibit 2



**Exhibit 3**

