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Arizona Court of Appeals Determines Whether Subsidiaries Are Part of Unitary Business

The Arizona Court of Appeals found that two of a taxpayer's subsidiaries engaged in financing and investment management activities were not part of its unitary group because they performed an accessory function that was not part of the basic operations of the business.¹ However, the Court concluded that a third subsidiary that held and managed the taxpayer's trademarks was a member of the unitary group because it engaged in basic operations of the business.

Background

The taxpayer, an operator of a worldwide commercial printing business, maintained a sales office in Arizona. The taxpayer filed combined Arizona corporate income tax returns with some of its affiliated corporations, but the returns did not include three separate subsidiaries. One of the subsidiaries ("Receivables") was a Nevada corporation that purchased accounts receivable and engaged in factoring. A second subsidiary ("Caslon") was a Delaware corporation that supplied investment management services. The third subsidiary ("Heritage") was a South Carolina corporation that held and managed trademarks transferred to it by the taxpayer.

After an audit, the Department of Revenue determined that the three subsidiaries should have been included in the taxpayer's unitary combined return. The Board of Tax Appeals reached the same conclusion on appeal. The Tax Court subsequently held that while Receivables and Caslon were not part of the taxpayer's unitary business, Heritage was part of the unitary business. Both parties appealed the Tax Court decision to the Arizona Court of Appeals.

Determination of Unitary Business

In the case of an affiliated group of corporations with operations in multiple states, courts apply the unitary business principle to determine whether a particular corporation is sufficiently interconnected or has a flow of value with a member of the affiliated group to require the inclusion of the corporation's income in the unitary combined group's tax base.² If affiliated corporations constitute a unitary business, Arizona requires them to file a combined tax return.³ The Court of Appeals examined a previous opinion and the state's regulations in determining the unitary business analysis to apply.

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¹ *R.R. Donnelley & Sons Co. v. Department of Revenue*, Arizona Court of Appeals, Division One, No. 1 CA-TX 08-0007, April 29, 2010.

² *F.W. Woolworth Co. v. Taxation and Revenue Department*, 458 U.S. 354 (1982).

³ ARIZ. ADMIN. CODE R15-2D-401(B).

In *State ex rel. Arizona Department of Revenue v. Talley Industries, Inc.*, the Court of Appeals adopted a “**substantial interdependence of basic operations among the various affiliates**” test to make a unitary business determination in Arizona.⁴ A key factor in the *Talley* analysis is the distinction between “basic operations” and “accessory” functions. **Services such as centralized management or control, financing, research, legal, accounting or other internal services rendered by one branch or affiliate to another qualify as accessory services.** These services are considered as an accessory to the operation of the business and can be charged to the various operations. **The Court explained that accessory services are not contained in the product or its delivery to the customer.**⁵

The Court also considered an Arizona regulation in determining whether the taxpayer and any of its subsidiaries constituted a unitary business.⁶ Under the regulation, the following threshold characteristics are necessary to consider a group of entities to be a unitary business: (1) the entities comprising the unitary business are owned or controlled, directly or indirectly, by the same interests that collectively own more than 50 percent of the voting stock; (2) the entities or components share common management and (3) the entities or components have reconciled accounting systems.⁷ If these three characteristics are evident, the entities also must demonstrate operational integration. The regulation lists 15 factors that may be considered in determining operational integration, including the same or similar business conducted by the entities or the vertical development of a product by the entities.⁸

Financing and Investing Subsidiaries Not Part of Unitary Business

The Court found that Receivables and Caslon were not part of the unitary business group because they provided accessory services for the taxpayer. While Receivables purchased and factored accounts receivable, mainly for the taxpayer, Receivables also received significant revenue from third-party purchases. The Court found that Receivables’ activities were similar to, yet less extensive than, the functions that failed to establish a unitary business in *Talley*. The Department did not distinguish the factoring services from similar services performed for any other large company. Further, there was no evidence that the transactions between Receivables and the taxpayer were at anything other than a fair market price. Because Receivables did not pass the unitary business test established in *Talley*, the Court did not consider the factors specified in the regulation.

The services performed by Caslon also failed to satisfy the *Talley* test. Caslon’s activities included buying and selling investment assets; receiving dividends, interest and other passive income; and borrowing and lending money at arm’s length to members of the corporate group. Most of Caslon’s property consisted of intangible personal property investment assets. Caslon and the taxpayer did not share any employees, advertising, legal services or centralized purchasing. Similar to Receivables’ activities, Caslon’s activities

⁴ 893 P.2d 17 (Ariz. Ct. App. 1994), quoting Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, ¶ 8.11[5] at 8-92 and ¶ 8.11[4][c] at 8-90 to 8-91 (2000).

⁵ 893 P.2d 17 (Ariz. Ct. App. 1994).

⁶ ARIZ. ADMIN. CODE R15-2D-401(D), (E).

⁷ ARIZ. ADMIN. CODE R15-2D-401(D).

⁸ ARIZ. ADMIN. CODE R15-2D-401(E).

constituted accessory services rather than basic operational activities. To the extent Caslon utilized the investment assets and other intangibles such as the investment assets were involved, such assets were not part of the taxpayer's product or its delivery.

Trademark Holding Company Part of Unitary Business

The taxpayer formed Heritage as a subsidiary to hold and manage its trademarks. Heritage entered into a formal licensing agreement in which it granted the taxpayer a non-exclusive license to use the trademarks in exchange for royalties. Even though the licensing agreement was non-exclusive, Heritage did not license or attempt to market the trademarks to any other entity.

The Court distinguished *Talley* and found that Heritage was part of the unitary business. The trademarks were fully and completely operationally integrated with the delivery and distribution of the product itself. Delivery of the product, including the identity of the producer, was not an accessory function. Thus, Heritage was part of the basic operations and also was functionally interdependent with other members of the taxpayer. Under the *Talley* test, Heritage was part of the taxpayer's unitary business.

The Court also found that Heritage was part of the unitary business under the regulation that was promulgated after *Talley*.⁹ The taxpayer noted that the regulation requires a substantial transfer of materials or goods between the entities in order for there to be a unitary business.¹⁰ As a result, the taxpayer argued that there was no transfer of materials as required by the regulation because the trademarks were intangible assets. The Court disagreed with the taxpayer and noted that Arizona courts have concluded, in similar situations, that for purposes of that regulation, intangibles are analogous to tangible products. Case law and the purpose of combined reporting supported the Court's conclusion that trademarks may be treated like tangible products under the unitary business standard.

The Court noted that the regulation includes a total of 15 factors that may be considered in determining whether operational integration exists.¹¹ The taxpayer argued that none of the factors applied to Heritage, but the Court found that five of the factors applied:

- The same or similar business was conducted by the components of the business, since Heritage's role with respect to the trademarks was to be an integral part of the delivery of the taxpayer's products and services;
- Components of the business (manufacturing, distribution and sales) vertically developed the product;
- There was a transfer of materials, goods, products and technological data and processes between components of the business;
- Sales or leases occurred between components of the business, through the non-exclusive licensing agreement between Heritage and the corporate parent; and

⁹ See ARIZ. ADMIN. CODE R15-2D-401(D), (E).

¹⁰ ARIZ. ADMIN. CODE R15-2D-401(G).

¹¹ See ARIZ. ADMIN. CODE R15-2D-401(E).

- Other integration between components of the business at the basic operational level occurred because Heritage was an intangible holding company that only did business with its corporate parent.

Commentary

This decision, which could be appealed by either party, provides useful guidance in determining whether subsidiaries are part of a unitary business in Arizona, and potentially in other states that use similar unitary business tests. The subsidiaries that provided financing and investment management activities were not part of the unitary business because they performed accessory services. In contrast, the trademark holding company was found to be part of the unitary group. This holding is debatable because the trademark holding company neither had tangible property nor did it directly contribute to the delivery and sale of the product. However, the Court focused on the facts that the trademark was included on the product and that the trademarks were not licensed to any other companies. If these factors were not present, a court might find in certain instances that a trademark holding company is not automatically part of a unitary group. Perhaps most notably, the Court delved into both the facts and relevant law pertaining to the definition of a unitary business and did not fall back on a more flimsy analysis that “common control and intercompany transactions equals a unitary business.”

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