

Arizona Continues to Chart Novel Course in Defining Unitary Relationships

by Amy Silverstein and Andres Vallejo

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With its decision in *Arizona Department of Revenue v. Talley Industries Inc.*, 893 P.2d 17 (1994), the Arizona Court of Appeals established Arizona's unitary standard as perhaps the most objective and narrow in the country. Also known as the "intermediate" approach to unitary combination, Arizona's standard essentially requires that substantial interdependence of basic operations exist among a group of companies before they can be unitary. Though sometimes frustrating to companies desiring to be unitary, this approach provides far more certainty for taxpayers and the taxing authorities than the much more subjective approaches of states such as California, while still, we believe, advancing the fundamental goal of the unitary doctrine: to reflect accurately income of an inseparable group of companies. Indeed, Jerome R. Hellerstein and Walter Hellerstein endorse this approach in their *State Taxation* treatise. See Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, para. 8.09[4] (3rd ed. 1998). (For the full text of the Arizona Court of Appeals' decision in *Talley Industries*, see 94 STN 183-3.)

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The few cases decided since *Talley* all have reconfirmed that Arizona's unitary standard really is as narrow as it appeared in *Talley* to be. But the most recent unitary case in Arizona has, perhaps, taken the doctrine to a new level, narrowing the standard even further. Though it is an unpublished trial court decision, not appealed to the Arizona Court of Appeals, and thus lacks precedential value, *The Crawford Group Inc., et al. v. Arizona Department of Revenue*, TX1996-000486 (Superior Court of Arizona, Arizona Tax Court, Nov 13, 2000) (referred

to as *Enterprise*) is instructive because it indicates how Arizona courts may apply Talley's unitary standard in similar cases.

Overview of Arizona Unitary Standard Before *Enterprise*

In *Talley*, a parent corporation sought to be combined with its 25 wholly owned subsidiaries operating diverse businesses such as supplying high-technology products for defense and industrial uses, manufacturing timepieces and timekeeping instrumentation, importing clothes, and transacting in real property for development. Despite Talley's control of its subsidiaries through centralized management, which the state essentially conceded, and other extensive connections between the companies, the court held that the companies were not unitary.

Rejecting more subjective unitary tests, such as California's, as "'extensive, time consuming, and burdensome,'" *Talley*, 893 P. 2d at 23 (internal citations omitted), the court adopted the "intermediate" approach and with it, the basic operations interdependence test. That is, the court required "a substantial interdependence of basic operations among the various affiliates or branches of the business" in order for separate corporations to be unitary. *Id.* at 24 (citations omitted). In the court's view, this approach "'provides a quantifiable, objective test of the unitary business.'" *Id.* (citations omitted; emphasis added). In adopting this approach, the court also rejected centralized management or control, financing, research, legal, accounting, or other internal services rendered by one branch or affiliate to another as contributing to a unitary finding, explaining that the costs of these activities "can be charged to the various operations by using generally accepted accounting methods." *Id.* at 25.

In the court's view, Talley and its subsidiaries did not constitute a single unitary group because they did not exhibit substantial operational integration. The ties that existed in *Talley* were all capable of measurement, and in fact had been charged to the subsidiaries. The court found that there was "no substantial interrelationship between the subsidiaries," i.e., "no transfers of materials, products, goods, technological data relating to products, processes, machinery, or equipment." *Id.* at 19. Indeed, the court believed that Talley and its subsidiaries exhibited "[n]o basic operational ties." *Id.*

While *Talley* informs readers of what does not constitute substantial operational integration, it is somewhat more challenging to glean from *Talley* what "substantial operational

integration" is. Generally, the court described "substantial operational integration" as interdependence concerning activities that make up the basic operations of a business. The court noted "the difficulty of determining the amount of income attributable to various stages of producing, refining, manufacturing, transporting, buying, selling, and the like, conducted in different states," *id.* at 25, and "the elusive efforts to determine the proper cost to be attributed to articles produced or manufactured by one branch or affiliate and sold to another." *Id.* (citations omitted). In a subsequent case, the court indicated that "basic operations" means "those concrete business activities whose performance directly yields revenue to the enterprise." *F.W. Woolworth Co., Kinney Shoe Corp., and Kinney Service Corp. v. State of Arizona*, 1 CA-TX 97-0007 (Dec 11, 1997).

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These passages suggest that substantial operational integration requires intercompany transactions involving the core operations of the business, and possibly is limited to vertical integration. For example, under *Talley*, a manufacturer of widgets and a controlled subsidiary selling exclusively those widgets would be unitary. Also, a mining company that sells raw materials to a controlled subsidiary to manufacture the subsidiary's products would be unitary under *Talley*. Possibly, manufacturer-distributor relationships in which the subsidiary sells, among other products, a large quantity of the parent's products would satisfy the substantial operational integration standard.

The cases following *Talley* essentially reconfirmed its holding but generally did not shed much new light on Arizona's unitary standard. Remarkably, in each of these cases, just as in *Talley*, the Department of Revenue succeeded in decombining the entities in question. *F.W. Woolworth Co., Kinney Shoe Corp., and Kinney Service Corp. v. State of Arizona*, 1 CA-TX 97-0007 (Dec 11, 1997) (chain of retail stores lacked substantial operational integration, so not allowed to file a combined return); *Jensen Tools Inc. v. Arizona Department of Revenue*, No. 1008-92-I (Sep 9, 1997) (company engaged in mail-order catalog sales of tools and tool kits not unitary with its parent, a manufacturer of similar products, due to the absence of substantial operational integration because the subsidiary did not sell parent's products). (For the full text of the Arizona Board of Tax Appeals' ruling in *Jensen Tools*, see *Doc 97-29035* (5 pages) or 97 STN 208-2.)

The Enterprise Case

In the most recent decision addressing the unitary standard in Arizona, *Enterprise*, a trial court suggested that the standard articulated in *Talley* may be applied even more narrowly than previously thought. Enterprise, a national car rental company, was organized as a series of regional operating companies under a common parent (the Enterprise Parent). Each subsidiary operated in a distinct geographic location under the same name and logo, and according to the same procedures, as the others. The office layouts and systems for checking out and

checking in cars were generally standardized. The Enterprise Parent, essentially a holding company, owned the Enterprise intangibles, such as trademarks and trade names, and licensed them to the operating subsidiaries. It also operated a national car reservation system for the benefit of all the subsidiaries. The structure permitted a customer to call a 1-800 number to reserve a car from Enterprise anywhere in the country.

The Enterprise Parent provided various centralized services to all the regional operating subsidiaries, including approximately 80 percent of all required administrative services (e.g., finance, treasury, accounting, tax, legal, and marketing); centralized purchasing for supplies; and software. It developed and implemented a national advertising campaign on behalf of the subsidiaries. And, the Enterprise Parent operated a centralized computer system from which the subsidiaries accessed documents essential to the day-to-day operations of the car rental business (e.g., rental receipts and lease contracts). The subsidiaries paid for all of the services provided by the Enterprise Parent but did not pay a royalty specifically for the use of the Enterprise name and logo. The charge to each subsidiary was based on the entity's proportional use of the parent's services.

For a change, in *Enterprise*, the department found itself arguing for unitary combination. The narrow unitary standard that the department successfully had established in prior cases now benefited the taxpayer. In an attempt to reconcile past cases, the department argued that *Talley* and the subsequent cases were distinguishable because the Enterprise Parent and its subsidiaries were "essentially a single business throughout the country." Defendant's Cross-Motion for Summary Judgment, at 2, *The Crawford Group Inc., et. al. v. Arizona Department of Revenue*, TX1996-000486 (Superior Court of Arizona, the Arizona Tax Court, Nov 13, 2000). The department explained:

Each subsidiary provides the same basic service and product, uses the same name, and benefits from the unquantifiable effects of a national presence, a national identity, national advertising, and national reservation services. Enterprise is a single business and its Arizona income can only be reported on a unitary basis.

See *id.* Thus, the department essentially took the position that the prior cases left room for finding unity where there was no substantial operational integration, but there was synergy arising from the identical nature of the businesses conducted by the commonly owned corporations.

The *Enterprise* court rejected the Department's position, and strongly reaffirmed *Talley's* vitality. The court found that the connections between the Enterprise Parent and the subsidiaries were limited to centralized services that could be measured by established accounting principles. Indeed, the Enterprise Parent charged the subsidiaries for these centralized services. Because there were no substantial transfers of the basic operational services of the companies, and no other substantial intercompany transactions at the basic operational level, according to the court, the Enterprise Parent and its subsidiaries did not exhibit substantial operational integration. Even assuming there were synergies between the subsidiaries as a result of engaging in exactly the same line of business, using the same processes and intangibles, in light of the lack of

substantial operational integration, the companies were not unitary.

The Aftermath of the *Enterprise* Decision

Because *Enterprise* is an unpublished trial court decision, it may not reverberate extensively in its own right. Moreover, while it is not binding on other courts, it does provide guidance regarding how courts might apply *Talley* to similar facts. In that way, it should inform both taxpayer planning and Department of Revenue treatment of taxpayers similar to *Enterprise* in audit and protests.

More generally, *Enterprise* reflects a quite narrow interpretation of *Talley* and Arizona's unitary standard. If Arizona

courts apply *Talley* narrowly, as they should, taxpayers and taxing authorities will benefit from the objectivity of Arizona's unitary standard. Arizona's approach to unitary combination minimizes the burdens and inefficiencies caused by the more subjective tests now used in many other states, while still advancing the fundamental goal of the unitary business concept: to reflect accurately income of an inseparable group of companies. While a very broad unitary test also would provide certainty for taxpayers and taxing authorities, such an approach inevitably clashes with constitutional limitations, likely resulting in more litigation than a narrow standard. Thus, Arizona's approach has much to commend it, and quite possibly should be a model for other states to follow. ☆

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