



1 During the Audit Period, CEDC's entire assets consisted of its investments in YCA and CEYC,  
2 CEYC's sole asset consisted of its investment in YCA. Neither CEDC nor CEYC had any sales,  
3 employees, or tangible personal property of their own. Consequently, all of the gains recognized by  
4 CEDC and CEYC resulted from the activities of YCA.

5 Appellants originally filed corporate income tax returns as part of a group under CalEnergy or its  
6 successor for the years at issue. The Arizona Department of Revenue (the "Department") audited these  
7 returns and changed the filing method by excluding entities included in the original returns resulting in a  
8 select combination of only CEDC and CEYC. The Department then issued a notice of proposed  
9 assessment. The Department subsequently modified the assessment to separate the select combination  
10 into two separate company filings, one for CEDC and one for CEYC. After unsuccessfully protesting the  
11 modified assessment to the Department, Appellant now timely appeals to this Board.

12 DISCUSSION

13 The primary issue before the Board is whether CEDC and CEYC form a unitary business with  
14 CalEnergy that requires a combined Arizona income tax return to accurately determine their income. If  
15 they are not part of a unitary business, the Board must decide whether the sales of electricity at issue in  
16 this case were properly sourced to Arizona.

17 Arizona law allows the Department to require corporations to file combined returns and apportion  
18 their income if it is necessary to prevent the evasion of taxes or to clearly reflect the income of any such  
19 taxpayer. A.R.S. § 43-942. Pursuant to this statute, the Department generally requires corporations to  
20 file combined returns if they operate as a unitary business.

21 Members of a unitary business derive income from their own business efforts plus the efforts of  
22 other members of the unitary business operation. *Caterpillar Tractor Co. v. Lenckos*, 417 N.E.2d 1343,  
23 1347 (Ill. 1981). Members may be horizontally integrated, as are segments of a railroad operated in  
24 several states. *State v. Talley*, 182 Ariz. 17, 893 P.2d 17 (App. 1994). Or they may be vertically  
25 integrated, as are companies that manufacture, produce, and sell at retail, doing business in several

1 states. *Id.* Because of the existence of substantial transactions, interrelations, or interdependence of  
2 basic operations among the various income-earning entities, it is difficult to determine the correct tax  
3 liability for a member of a unitary business *Id.* Thus, the unitary business doctrine was created because  
4 states were unable to establish a fair arm's length price for goods transferred, or basic services rendered,  
5 between controlled branches of an enterprise. *Id.*

6 To qualify as a unitary business in Arizona, companies must satisfy certain threshold  
7 requirements established by the Department. Companies must show that they share 1) common  
8 ownership, 2) common management, and 3) reconciled accounting. A.A.C R15-2D-401(D). The  
9 Department concedes that CalEnergy, CEDC and CEYC meet the threshold requirements. However, as  
10 the regulation further indicates, the presence of these three characteristics alone is not sufficient to  
11 establish a unitary group "without evidence of substantial operational integration" among the members.  
12 R15-2D-401(E). Arizona courts have confirmed that substantial operational integration is necessary to  
13 establish a unitary business. *See, e.g., Talley*, 182 Ariz. 17 (App. 1994).

14 In *Talley*, the parent corporation owned twenty-five subsidiaries, ten of which operated in Arizona.  
15 Several of the subsidiaries manufactured and supplied commercial and high technology products for  
16 defense and industrial uses. Others manufactured timepieces and timekeeping instrumentation, imported  
17 men's and women's apparel, and bought and sold real property primarily for commercial and industrial  
18 development. *Talley* performed a number of services for its subsidiaries, including tax return preparation,  
19 accounting, insurance, and employee benefits. *Talley* also borrowed funds, incurred corporate office  
20 costs, and acted as banker for its subsidiaries. *Talley* determined each subsidiary's salary guidelines,  
21 and its corporate officers served on each of the subsidiary's board of directors, supervising the operation  
22 of the subsidiary. Even so, the Arizona Court of Appeals found that no substantial interrelationship  
23 existed between the subsidiaries because there were virtually no operational ties among the subsidiaries,  
24 and combined reporting was not necessary to clearly reflect the taxable income earned in Arizona.  
25 *Talley*, 182 Ariz. at 18. Similarly, the circumstances of this case do not justify unitary apportionment.

1 Here, Appellants insist they are part of a horizontally integrated, multi-state business with  
2 substantial interdependence as evidenced by CalEnergy's provision of regulatory oversight, operational  
3 services and intangibles to the partners in YCA. The evidence does indicate that CalEnergy provides  
4 elements of management, direction and control to the Arizona operations such as financing, acquisition,  
5 construction, engineering, payroll, accounting, legal, tax, negotiations, and contracting activities.  
6 However, these services are capable of measurement; therefore, they do not demonstrate substantial  
7 interdependence at the basic operational level. *Id.*

8 CEDC and CEYC are partner-holding companies. Their only asset is their investment in YCA.  
9 There is no evidence that either CEDC's or CEYC's Arizona income is attributable to anything other than  
10 YCA's production and sale of electricity and steam. YCA's resources flow to its partners by using  
11 generally accepted accounting methods, not requiring unitary apportionment. In fact, while A.R.S. § 43-  
12 942 authorizes two or more *corporations* to file a combined report under certain circumstances, this  
13 authority is clearly limited to corporations and does not include partnerships.

14 Neither CEDC nor CEYC have demonstrated the difficulty in determining their true income or the  
15 necessity of a combined return to accurately reflect their Arizona income. Neither have they sufficiently  
16 demonstrated that they form a unitary business with CalEnergy.

17 This being the Board's finding, Appellants next contend that, although they originally included  
18 100% of YCA's sales in the Arizona numerator of the sales factor, the sales of electricity to San Diego  
19 should now be treated as California sales and excluded from the Arizona numerator.

20 A.R.S. § 43-102(A)(5) imposes tax on each corporation with a business situs in this state. The  
21 tax is measured by the taxable income that results from activity within this state or is derived from sources  
22 within this state. "Any taxpayer having income from business activity which is taxable both within and  
23 without this state shall allocate and apportion net income as provided in [the Uniform Division of Income  
24 for Tax Purposes Act ("UDIPTA")] . . . ." A.R.S. § 43-1132(A).  
25

1 Appellants concede that they did not pay tax to California on the activities at issue. Nevertheless,  
2 they argue that they are entitled to allocate income, meaning they can exclude the sales of electricity to  
3 San Diego from the Arizona numerator, because California "has jurisdiction to subject the taxpayer to a  
4 net income tax regardless of whether, in fact, the state does or does not." A.R.S. § 43-1132(2).

5 Because California takes the position that electricity is an intangible and does not tax its sale, the  
6 Board finds that it does not have jurisdiction to tax Appellants. Accordingly, UDITPA and A.R.S. § 43-  
7 1146 do not apply. Therefore, 100% of CEDC's and CEYC's activity was properly sourced to Arizona .

8 CONCLUSIONS OF LAW

9 1. Appellants are not part of a unitary business. See A.R.S. § 43-942; *State v. Talley*, 182  
10 Ariz. 17, 893 P.2d 17 (App. 1994).

11 2. The sales of electricity at issue in this case were properly sourced to Arizona. See  
12 A.R.S. § 43-102(A)(5).

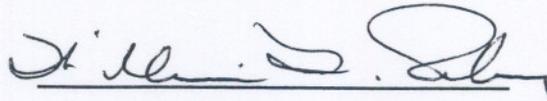
13  
14 ORDER

15 THEREFORE, IT IS HEREBY ORDERED that the appeal is denied, and the final order of the  
16 Department is affirmed.

17 This decision becomes final upon the expiration of thirty (30) days from receipt by the taxpayer,  
18 unless either the State or taxpayer brings an action in superior court as provided in A.R.S. § 42-1254.

19 DATED this 9th day of March, 2004.

20 STATE BOARD OF TAX APPEALS

21   
22 \_\_\_\_\_  
23 William L. Raby, Chairperson

24  
25 WLR:ALW

1 CERTIFIED

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