BEFORE THE STATE BOARD OF TAX APPEALS
STATE OF ARIZONA
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R.R. DONNELLY & SONS COMPANY and SUBS, Appellant, vs. ARIZONA DEPARTMENT OF REVENUE, Appellee.	Docket No. 1934-04-I NOTICE OF DECISION: FINDINGS OF FACT AND CONCLUSIONS OF LAW

The State Board of Tax Appeals, having considered all evidence and arguments presented, and having taken the matter under advisement, finds and concludes as follows:

FINDINGS OF FACT

The Arizona Department of Revenue (the "Department") audited R.R. Donnelly & Sons Company ("Appellant") for tax years ending December 31, 1990 through December 31, 1999 (the "Audit Period.") During these years, Appellant engaged in the business of commercial printing in multiple states, including Arizona where Appellant filed corporate income tax returns. As a result of the audit, the Department combined several of Appellant's subsidiaries on its combined State returns in order to determine Appellant's taxable income under Arizona's Uniform Division of Income for Tax Purposes Act (UDITPA). As a result of the subsidiaries' inclusion on Appellant's combined returns, the Department assessed additional income and interest against Appellant in March 2002.

Appellant timely protested the assessment, and, in May 2003, the Department issued a modified assessment incorporating returns filed by Appellant. In November 2003, the Department and Appellant executed a Partial Closing Agreement. Appellant now timely appeals to this Board only the amount of the assessment attributable to the inclusion of three specific subsidiaries: R.R. Donnelley Receivables, Inc. ("Receivables"), which purchases and factors accounts receivable; Heritage Preservation Corporation

("Heritage"), which holds and manages intellectual property, and Caslon, Inc. ("Caslon"),which manages investments.

DISCUSSION

The issue before the Board is whether the Department properly included the income from Receivables, Heritage and Caslon in Appellant's income on its Arizona combined return.

A.R.S. § 43-492 provides the following:

> A. In any case of two or more corporations owned or controlled directly or indirectly by the same interest, the department may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such taxpayers, if it determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such taxpayer.
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> B. For the purpose of enforcing this section, the department may require the filing of a combined report . . . .

The Department generally requires corporations to file combined returns if they operate as a unitary business.

A unitary business may consist of companies that are horizontally integrated, as are segments of a railroad operated in several states, or vertically integrated, as are companies that manufacture, produce, and sell at retail in multiple states. *State v. Talley*, 182 Ariz. 17, 25, 893 P.2d 17, 25 (App. 1994). It is difficult to determine the correct tax liability for a member of a unitary business because of the existence of substantial transactions, interrelations, or interdependence of basic operations among the various income earning entities. *Id.* The entities in a unitary business derive income from their own business efforts plus the efforts of other members of the unitary business operation. *Caterpillar Tractor Co. v. Lenckos*, 417 N.E.2d 1343, 1347 (Ill. 1981). Thus, the unitary business doctrine was created because states were unable to establish a fair arm's length price for goods transferred, or basic services rendered, between controlled branches of an enterprise. *Talley*, 182 Ariz. at 25, 893 P.2d at 25.

In determining whether or not a business is unitary, the Arizona Court of Appeals in *Talley* concluded that the "intermediate approach" requiring substantial operational integration is the proper method to use. *See, generally*, I Jerome R. Hellerstein and Walter Hellerstein, State Taxation (2d ed.

1993).[1] The court cites to a Pennsylvania case that applied the intermediate approach to find, in part, that in allocating to a state its fair share of income reflective of activity in that state and in excluding income not derived from that state's activities, the factors attributable to the outside activity may be excluded if a multistate business is conducted in a way that one, some or all of the business operation outside the state are independent of and do not contribute to the business operations within the state. *Pennsylvania v. ACF Industries, Inc.* 441 Pa. 129, 271 A.2d 273 (1970).

Appellant argues that the income of Receivables, Heritage and Caslon should be excluded from Appellant's combined Arizona return because the relationship between Appellant and the three subsidiaries does not meet the test for substantial integration at the basic operational level under *Talley*. According to Appellant, none of the three subsidiaries at issue was engaged in the printing business, nor did they provide printing-related services or products. No business activities took place in Arizona during the Audit Period. The internal services provided by these affiliates were provided at arms-length prices and charged to the operating entity using generally accepted accounting methods.

The Department argues that the facts show that there is substantial integration at the basic operational level between Appellant and the three subsidiaries. Having reviewed the facts, the Board agrees.

Receivables is a factoring company in the business of purchasing and factoring accounts receivable. It was incorporated in Nevada in 1986. During the Audit Period, in addition to purchasing accounts receivable, it engaged in cash application, collection activities, analysis of accounts receivable balances to determine bad debt write-offs, maintenance of books and records and the performance of business activities related to the above. These activities applied to obligations owed to Appellant by its customers for printing related products and services, including amounts derived from sales to Arizona customers.

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[1] Arizona regulations also require companies qualifying as a unitary business to not only demonstrate common ownership, common management, and reconciled accounting, but also, "substantial operational integration" among the members. A.A.C R15-2D-401(D) and (E).

As part of its operations, Receivables loaned money to Caslon, recognized intercompany interest income from these loans, and paid dividends to Appellant. Receivables paid $25 million dollars annually in dividends to Appellant in tax years 1994 through 1999. Third-party revenue never exceeded 9% of Receivables' total revenue during the Audit Period.

Appellant formed Heritage in 1995 and transferred the intellectual property created as a result of its printing business. During the Audit Period, Heritage held and managed this intellectual property, consisting of Appellant's service marks, trade names and a printer's mark (the "Trademarks"). It owned no other intellectual property. Heritage did not license the Trademarks to any entity outside Appellant's group and had no third party revenue. All of its royalty revenue consisted of royalties received from Appellant, and all of Appellant's royalty expense was paid to Heritage.

During the Audit Period, Caslon was primarily involved in intercompany lending and borrowing among members of Appellant's federal consolidated return. With the exception of one isolated event in 1998, Caslon had no third-party income and did not engage in lending activities with any company outside Appellant's corporate family. Interest income accounted for more than 97% of Caslon's total revenue. Caslon paid dividends ranging from 20 million to 30 million dollars to Appellant in tax years 1994 through 1999. All the dividends paid to Appellant from Receivables, Heritage and Caslon were excluded from the Arizona tax base in Appellant's original Arizona filings.

In order for the three subsidiaries at issue to be excluded from Appellant's unitary business, they must demonstrate that they were truly independent of Appellant at the operational level during the audit Period. *Talley*, 182 Ariz. 17, 893 P.2d 17. The facts show that each company was formed from Appellant's existing assets and could not exist independently from Appellant. The subsidiaries had no significant income or business with anyone other than Appellant. Virtually 100% of their revenue was generated through their interaction with Appellant. Thus, there was no commercial viability separate and apart from Appellant. The subsidiaries are part and parcel of Appellant's core business operation. In fact, the functions of the three companies were all performed by Appellant on an internal basis before

their corporate formation. For the foregoing reasons, the Board finds that Receivables, Heritage and Caslon are substantially integrated operationally with Appellant and must be included in Appellant's combined Arizona return for the years at issue.

CONCLUSIONS OF LAW

Receivables, Heritage and Caslon are substantially integrated operationally with Appellant; therefore, the Department properly included the income from these subsidiaries on Appellant's Arizona combined return. *State v. Talley*, 182 Ariz. 17, 893 P.2d 17 (App. 1994).

ORDER

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

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

DATED this 27th day of September, 2005.

STATE BOARD OF TAX APPEALS

Janice C. Washington, Chairperson

JCW:ALW

CERTIFIED

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