COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

No. 1 CA-TX 12-0005

HOME DEPOT U.S.A., INC. AND AFFILIATES,
Plaintiffs-Appellants,

vs.

ARIZONA DEPARTMENT OF REVENUE,
AN EXECUTIVE ADMINISTRATIVE AGENCY OF THE STATE OF ARIZONA,
Defendant-Appellant.

AMICUS CURIAE BRIEF OF MULTISTATE TAX COMMISSION IN SUPPORT OF ARIZONA DEPARTMENT OF REVENUE

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I. INTEREST OF THE *AMICUS CURIAE*

Amicus curiae Multistate Tax Commission ("the Commission") submits this brief in support of the Appellant, State of Arizona, Department of Revenue ("the Department") in this appeal from the determination of the Arizona Tax Court holding that Home Depot USA, Inc. and Affiliates ("Home Depot" or "the taxpayer") was engaged in a single unitary business with its wholly-owned subsidiary, Homer TLC, Inc. ("Homer").

The Commission has a significant interest in this case because the correct application of the unitary business principle is central to the states' administration of their corporate income tax systems. If the decision below is reversed based on an unduly restrictive and ridged concept of what constitutes a unitary business, it could create uncertainty and confusion in the administration of state taxes which could resonate beyond the state's borders. A reversal could also encourage more taxpayers to undertake inappropriate tax-shifting strategies, increasing audit and compliance burdens for the states.

The Commission is the administrative agency for the Multistate Tax Compact ("Compact"), which became effective in 1967. *See* RIA *All States Tax Guide*, ¶ 701 *et seq*. (RIA 2005).[1] Today, forty-six states and the District of

[1] The validity of the Compact was upheld in *United States Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. 452 (1978).

Columbia are members of the Commission. Nineteen states have legislatively established full membership. Six additional states are sovereignty members and twenty-two are associate members.[2]

The purposes of the Compact are: (1) facilitation of proper determination of state and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes; (2) promotion of uniformity or compatibility in significant components of tax systems; (3) facilitation of taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and (4) avoiding duplicative taxation. *See* Compact, Art. I.

The Commission's purpose in filing this brief arises from its twin goals of facilitating the proper determination of state tax liability and promoting uniformity and consistency in the administration of formulary-based systems for the taxation of multistate businesses.

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[2] This brief is filed by the Commission, and not on behalf of any particular member state, except Arizona. Compact Members are: Alabama, Alaska, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. Associate Members: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

The Arizona Tax Court appropriately determined that Home Depot and Homer, a "Delaware Intangibles Holding Company," were part of a vertically-integrated unitary business. Home Depot and Homer engaged in substantial intercompany transactions consisting of licensing by Homer to Home Depot of a critically-important intangible operating asset, the "goodwill" of Home Depot, embodied in its trade names, trademarks and service marks. *See, e.g., Marshak v. Green*, 746 F.2d 927, 929 (2nd Cir.1984)(trademarks and trade names embody goodwill of on-going business). The legal rights to those assets were transferred from Home Depot to Homer in a tax-free exchange with no reported consideration in 1991, and then immediately licensed back to Home Depot.

The simple "license-in, license-out" transaction described above would have allowed Home Depot to shift billions of dollars-- more than half of its reportable profits--out of the pool of income subject to apportionment in Arizona. The artificial shifting of reportable earnings from Home Depot to Homer was exactly the type of result the Arizona legislature intended to avoid when it adopted the combined reporting requirement under A.R. S. § 43-942 in 1978 (originally codified as A.R.S. § 43-947(A)). Under combined reporting, the incomes of both Homer and Home Depot are included on a single report and then apportioned based on the percentage of business activities of those entities in the states. *See* A.R. S. § 43-1139 (2003). Twenty-two other states and the District of Columbia have now mandated combined reporting for the same purpose: to ensure a reasonable measure of the in-state earnings of unitary businesses conducted through multiple legal entities. *See* CCH Smart Charts, *Income Allocation and Apportionment*, *Mandatory Combined Reporting* (Wolters-Kluwer 2012).

The Commission is directly concerned with promoting uniformity among states in the application of the unitary business principle. The Commission is equally concerned with ensuring the accurate determination of state tax liability for multistate taxpayers. In furtherance of those goals, the Commission has adopted a model combined reporting statute for the states' use in achieving uniformity, consistency and accuracy in determining state income liabilities. The model statute defines a unitary business as:

> a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.
>
> MTC Model Combined Reporting Statute (2006), Section 1(f).[3]

This definition is based on language from the seminal U.S. Supreme Court case of *Container Corporation of America, Inc. v. Franchise Tax Board*, 463 U.S.

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[3] The model statute may be found at: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf. Three states (West Virginia, Massachusetts and Wisconsin) and the District of Columbia have adopted combined reporting since 2006 and all have made use of the Commission's model statute in their laws.

159, 164-5 (1983). Given the operational relationship between Homer and Home Depot, there can be no serious question that they would be considered as engaging in a single unitary business under the Court's definition announced in *Container*, or indeed, under any recognized articulation of the unitary business concept. Homer derived 100% of its income from licensing critical intangible property to Home Depot. Home Depot could not function without the name recognition represented by the intangible trademarks now held by Homer and licensed to Home Depot. The two entities are interdependent, integrated and interrelated in every sense.

This case represents an important opportunity to reaffirm Arizona's reliance on fundamental unitary business principles in applying the combined reporting requirements of A.R.S. § 43-942. The actual holdings of Arizona's prior cases applying the unitary business principle to combined reporting, *State ex rel. Arizona Department of Revenue v. Talley Industries, Inc.*, 182 Ariz. 17, 893 P.2d 17 (App. 1994) and the more recent case of *R.R. Donnelley & Sons Company v. Arizona Department of Revenue*, 224 Ariz. 24, 229 P.3d 266 (App. 2010), suggest that this court's application of the principle is in accord with the jurisprudence of the U.S. Supreme Court and the states, as well as the MTC's model statute which is based on that jurisprudence. The Commission accordingly urges this court to affirm the Tax Court's well-reasoned decision finding that Home Depot and Homer were engaged in a single unitary business.

II. STATEMENT OF THE CASE.

The sole question for review in this appeal is whether the Arizona Tax Court was correct in concluding that Home Depot U.S.A. and Subsidiaries was engaged in a unitary business with Homer, Inc. for the fiscal years ending 1/30/00, 1/28/01 and 2/3/02, and thus required by A.R.S. § 43-942 to be included on the combined corporate income tax returns filed by Home Depot U.S.A. and Subsidiaries for those tax periods.

A. Course of Proceedings.

The Department audited Home Depot U.S.A.'s returns and issued a proposed assessment in 2005. (Electronic Index of Records ("R") 1, ¶ 18; R.5 ¶ 1.) That proposed assessment was protested and a claim for refund was filed by the taxpayer, which was subsequently denied by the Department. (R.1, ¶¶ 25-30; R.5, ¶¶ 11-14.) An administrative hearing officer subsequently ruled in favor of the Department and against the taxpayer. (R. 1, ¶¶ 33-37; R.5, ¶1.)

In 2006 the taxpayer filed an appeal with the Arizona Tax Court. (R.1). On June 25, 2009, in response to cross motions for partial summary judgment, the Arizona Tax Court held that Homer, Inc. was engaged in a unitary business with taxpayer and should have been included on the combined return, with a final judgment entered for the Department on December 1, 2011. (R.36; R.69.)

B. Statement of Facts.

In February of 1991, Home Depot transferred the legal ownership of its trademarks and trade names embodying its goodwill to a newly-created Delaware corporation, Homer, Inc. (R.17, ¶ 20; R.22, ¶ 24). Although the purported reason for the transfer of the intellectual property ownership was to "provide needed protection and management [for the property]" (*Opening Brief*, p. 4), at the time of the transfer Homer, Inc. was an empty shell with no employees.[4] Homer eventually hired four employees to maintain trademark registrations and write letters warning against trade name infringements. (R.17, Declaration of Steve Levy, ¶¶ 19, 21.)

The record does not indicate that there was any consideration given to Home Depot for the transfer of its trademarks representing goodwill, originally valued at $354 million in 1991. (R. 17, ¶ 22.) The Assignment of Trademarks simply recites that the transfer was accomplished "for consideration, the adequacy of which is hereby acknowledged." (R.17, Levy Decl., Ex. A, p. 1.) Immediately following Home Depot's assignment of its intangible property, Home Depot agreed to pay

[4] Homer Inc. did not hire its first employee, a paralegal, until July, 1991, some five months after the transfer, and apparently waited several months after that before it hired its first counsel. (R.17, Levy Decl., ¶¶ 19, 21.)

Homer a royalty equal to 1.5% of Home Depot's gross receipts for a license to use that intangible property – which it had just donated to Homer – in Home Depot's retail operations. (R.17, Levy Decl., Ex. D.) Home Depot then deducted those royalty payments from its income reported to Arizona and continued to do so during the years at issue, reducing its net income tax liability significantly. (R.22, ¶ 37, Exhibits 3, 4 & 5.) It would be hard to argue that the entire series of transactions (a "step transaction" in federal tax parlance) had any purpose other than the creation of an accounting justification for those royalty deductions.

Because Homer paid nothing for Home Depot's intangible property embodying its value as an on-going business, and because it had essentially no operating expenses related to the maintenance of that value, Homer's reported profits were a staggering $4,605,199,251 for the three years at issue in this case. (R.22, ¶ 37, Exhibits 3, 4 & 5.) During the same tax period, Home Depot reported $3,774,677,576 in profits. *Id.*[5] But Homer had only four employees, an attorney and three paralegals (R.17, Levy Decl., p.3), while Home Depot had approximately 227,300 employees in 1,134 stores at the end of the 2000 fiscal year. *See 2000 Home Depot Annual Report, Description of Business*, p. 32, *available at:* *http://www.slideshare.net/finance2/home-depot-annual-report-2000*. The

[5] Homer Taxable Income FYE 1/31/00: $789,470,450; FYE 1/31/01: $1,781,515,946; FYE 2/30/02: $2,034,212,855.
Home Depot Taxable Income: FYE 1/31/00: $1,739,025,297; FYE 1/31/01: $962,101,825; FYE 2/30/02: $1,073,550,545.

license-in, license-out transaction at issue in this appeal allowed Home Depot to claim two deductions for the same activity, eliminating more than half of its net income from taxation: first, it could claim deductions for creating and maintaining the value of its goodwill, and second, Home Depot could claim a deduction for paying a royalty to Homer for the very same goodwill it had donated in 1991.

Two valuation agreements were prepared by the taxpayer's accountants, in 1991 and again in 1999, purporting to establish an arms-length price for what a third party would be willing to pay for the trademarks and trade names embodying the goodwill Home Depot had created through years of (deductible) business investments. (R.17, Levy Decl., Ex. B ,¶¶ 23-24; R. 17, Ex. F, ¶¶ 30, 31.) Both valuation agreements caution that they were prepared solely for tax purposes, and should not be used as a basis for making any true economic decision. (R.17, Levy Decl., Ex. B, p.1; R.17, Ex. F, p. 14, "General Assumptions and Limiting Declarations.")[6] While the first valuation agreement concluded that Home Depot's intangible property was worth 1.5% of its gross sales, the second valuation, undertaken just eight years later, concluded that the intangible property was now worth 4% of Home Depot's gross sales, at least for tax purposes. (*Id*. at p.12.)

[6] The first appraisal, prepared twelve days after the parties had already agreed to a 1.5% royalty rate, states: "It is our understanding that this fractional appraisal will serve the Company's management in its corporate tax planning. This opinion of value may be invalid if used for any other purpose." (Ex. B, p. 1.)

Although the taxpayer claims that Homer engaged in substantial intellectual property licensing agreements with "third parties" (*Opening Brief*, p. 8), in fact the great majority of those agreements were with foreign subsidiaries of Home Depot (R.22, ¶ 30), who were ineligible for inclusion on the combined report because of their foreign status, but who were hardly independent parties. There is no evidence in the record that Homer purchased any rights to intellectual property from third parties, or that Homer licensed Home Depot's intellectual property to competing hardware stores, which might have allowed for a more realistic measure of the value of Home Depot's goodwill. (R.17., Levy Decl., p. 4.)

III. ARGUMENT

THE INCOMES OF HOMER AND HOME DEPOT SHOULD BE COMBINED BECAUSE BOTH ENTITIES ARE ENGAGED IN A SINGLE UNITARY BUSINESS, AND FAILURE TO COMBINE THEIR UNITARY INCOMES WOULD RESULT IN DISTORTION OF INCOME.

A. Introduction.

Under A.R.S. §43-942, the Department may require the filing of a combined report whenever it is necessary to clearly reflect the income of a taxpayer or in order to prevent evasion of taxes.[7] Pursuant to the state's long-standing regulation,

[7] The statute provides:

Allocation in the case of controlled corporations

A. In any case of two or more corporations owned or controlled directly or indirectly by the same interests, the department may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such

A.A.C. R15-2D-401(A), a combined report is required whenever the taxpayer and one or more other entities are engaged in a single unitary business.

Homer and Home Depot are engaged in a single vertically-integrated unitary business, namely, the retail sale of home improvement materials and services. Homer licenses the use of trademarks, trade names and other "marketing" intangible property to Home Depot, which is used prominently in Home Depot's retail business.

Home Depot could not function in the retail business without its trade names and trademarks, which embody its "goodwill," that is, the reason customers come through the door. *See, e.g., Visa U.S.A., Inc. v. Birmingham Trust National Bank*, 696 F.2d 1371, 1375 (Fed. Cir. 1982)(trade names embody goodwill); *Mitchell v. Mitchell*, 152 Ariz. 317, 732 P.2d 208, 210 (Ariz. 1987)(goodwill represents the intangible property value of a business over and above the value of its tangible property, which is "responsible for profits in a business").

Just as Home Depot could not operate without the license to use the intangible property now held by its wholly-owned subsidiary Homer, Homer could

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taxpayers, if it determines that such distributions, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such taxpayer.
B. For the purpose of enforcing this section, the department may require the filing of a combined report and such other information as it deems necessary unless the taxpayer has elected or is required to file a consolidated return pursuant to section 43-947.

not have reported its billions of dollars in net income without the on-going business operations of Home Depot, since its royalty payments were based on a percentage of Home Depot's gross sales. The two entities thus epitomize the concept of "substantial mutual interdependence" which the U.S. Supreme Court recognized as the hallmark of a unitary business relationship in *F.W. Woolworth Co. v. Taxation and Revenue Dept. of New Mexico*, 458 U.S. 354 (1982) and *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 166 (1983).

In *Container*, the Court noted that a unitary business can be characterized by a "substantial flow of value" (which includes, but is not limited to, a flow of tangible or intangible goods or services) that cannot be accurately captured or quantified. 463 U.S. at 164. The flows of value between Homer and Home Depot are substantial. Homer derives the entirety of its income from valuable property received from Home Depot, and earns almost all of its income from intercompany transactions licensing the use of that same property back to Home Depot.

Although the rights to license intellectual property like trade names and trademarks might be severable from the ownership of an on-going business in a legal sense, no academic, legal or accounting literature supports the idea that such values can be determined with precision. *See, e.g.*, J. McCarthy, *McCarthy on Trademarks and Competition*, ¶ 2:17 (West, 4th Ed. 1996); *see also*, Jacobsen, *Trademarks and Goodwill: Relationship and Value*, 12 J. of Contemporary Legal

Issues 193 (2001-2002). The very magnitude of the discrepancy between the two valuations in this case highlights the impossibility of accurately ascertaining a true market price for an asset so intrinsically connected to the value of an on-going business. The trademarks were allegedly worth 1.5% of Home Depot's gross sales in 1999, allowing Homer to siphon $789,470,450 out of Home Depot for the fiscal year ending 1/31/00, but a new accounting firm decided the trademarks were now worth 4.0% of Home Depot's gross sales, suddenly allowing Homer to siphon off an additional billion dollars of Home Depot's income for the fiscal year ending 1/31/01, for a total of $1,781,515,946.

As the Supreme Court noted in *Container*, 463 U.S. at 165-166, the kind of transactional accounting represented by the taxpayer's two appraisals is "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Accord, Mobil Oil v. Commissioner of Taxes (Vermont),* 445 U.S. 425, 438-439 (1980). In fact, the appraisals are full of conjecture and speculation as to what Home Depot's name recognition and customer loyalty might be worth to a hypothetical third party who wanted to open

1,300 hardware stores bearing the Home Depot name. (R.17, Ex. B, pp. 42-44; R.17, Ex. F., p. 12.)[8]

But even two consistent appraisals would not support the claim that the value of Home Depot's "goodwill" was accurately captured for either entity. The *potential* for distortion of income arising from a unitary business relationship is the springboard for application of the combined reporting requirement in A.R.S. § 43-942. Just as saliently for this appeal, however, is the *actuality* of the distortion which inevitably resulted from the original transfer of intangible property to Homer without recognized consideration. In a true market transfer of Home Depot's trade names and trademarks to a third party, Home Depot would have received substantial income for allowing another party to use its property. But nothing like that happened in this case. Rather than receiving a payment for transferring its valuable intangible property to Homer, Home Depot received nothing, and is now *paying* Homer for the right to use that property.

Moreover, Home Depot incurred and continues to incur expenses in developing and maintaining that goodwill[9], meaning it now claims two tax

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[8] "We found it necessary to forecast Company sales for a period of <u>fifteen years</u> in order to achieve a growth rate in the capitalization of the residual value which reflects a reasonable long-term growth rate." (Ex. B. at 43.)(emphasis supplied.) "We relied on [revenue] projections prepared by management for this approach." (Ex. F at 12.)

[9] For instance, in the fiscal year ending 1/20/99, Home Depot incurred $482.3 million in advertising expense. (R.17, Levy Decl., Ex. F, p. 10.)

deductions associated with its goodwill, while Homer claims none. Although Homer's four employees in Delaware perform important services for Homer, the primary source of Homer's income is not the activities of those four employees; it is the activities conducted by Home Depot's 237,300 employees in 1,134 nationwide stores.

The central inquiry before this court is whether Home Depot and Homer derived their incomes from a unitary enterprise, so that combination is appropriate to more clearly reflect the incomes of the two entities. The Commission believes that the evidence is overwhelming that Homer and Home Depot are engaged in a unitary enterprise. The evidence is equally compelling that combination of their incomes will more clearly reflect Home Depot's earnings in Arizona. Combination is accordingly required under A.R.S. § 43-942.

The taxpayer in its *Opening Brief* suggests otherwise. It argues that even in the face of overwhelming evidence that a taxpayer's in-state income is distorted as a result of transactions with related parties, combination is not permitted if: (a) an arms-length pricing study is prepared justifying the amount of royalty charged; (b) the trademarks being licensed do not appear on products sold to customers; and (c) the trademark owner also licenses the use of that property to third parties. (*Opening Brief*, p. 29.) The taxpayer's argument is based on a highly selective reading of *dicta* in *Talley Industries* and *R.R. Donnelley, supra*.

The Commission submits that the holdings in both cases clearly and unequivocally support the Tax Court's finding of a unitary relationship in this case, justifying the combination of income pursuant to A.R.S. § 43-942. Furthermore, this appeal presents a valuable opportunity for the court to clarify some analysis in its earlier decisions and to re-affirm the use of established unitary business concepts in determining when combination of entities is appropriate under Arizona law.

B. The Tax Court Properly Concluded that Homer was Engaged in a Unitary Relationship with Home Depot Where They Shared Operational Interdependence and Unitary Assets.

In adopting A.R. S. § 43-942, the Arizona legislature expressed its belief that combined reporting was the appropriate means to ensure that the Arizona earnings of taxpayers would be accurately determined where those taxpayers engage in a single ("unitary") business carried out through two or more legal entities. The facts of this appeal demonstrate that Homer and Home Depot are engaged in a single unitary business: retailing home improvement products and services.

In *State ex rel. Arizona Department of Revenue v. Talley Industries, Inc.*, 182 Ariz. 17, 893 P.2d 17 (App. 1994) this court held that the basis for any unitary determination among multiple entities is whether the entities contribute to each other's success and are mutually dependent upon each other, as evidenced by "the existence of substantial transactions, interrelations or interdependence of basic operations among the various income-earning subsidiaries." 182 Ariz. at 25, 893 P.2d at 25. This articulation of the unitary business principle is fully consistent with the definition of a unitary business established in U.S. Supreme Court precedent.

Talley addressed the attempted combination of eleven highly diverse and separate business lines, where the only suggested unitary connections between those business lines was the provision of centralized administrative services. The court held that combined filing was inappropriate where there was no evidence of a substantial interrelationship between the entities through operational ties, such as transfers of materials, products, goods, or technological processes. 893 P.2d at 19.

The result in *Talley* is within the mainstream of constitutional analysis, although many courts have held that shared administrative functions do create the potential for economies of scale which could support a unitary finding. *See, e.g., Gannett v. State Tax Assessor*, 949 A.2d 748, 750 (Me. 2008)(citing *Container Corp.*, *supra* at 179-180, for the proposition that the totality of facts and circumstances should be examined). *See also*, Hellerstein, *State Taxation*, ¶ 8.11 [5] (2nd. Ed. 1993).[10]

[10] The Commission's Model Allocation and Apportionment Regulation likewise provides that "centralized administrative functions" such as those described in *Talley* "may result in some degree of economies of scale." *Available at*:

Applying the *Talley* court's "substantial transactions, interrelations or interdependence of basic operations" standard to the present appeal, it is clear that Homer and Home Depot are engaged in a unitary business. They have substantial transactions between them: intellectual property worth hundreds of millions of dollars was transferred to Homer, and Homer has continuously licensed that property back to Home Depot in exchange for billions of dollars in annual royalties. The two entities have substantial inter-company transactions, well beyond the mere provision of accessory internal services or functions. Homer derives 99% of its income from licensing those marks to Home Depot and other affiliates. Home Depot, meanwhile, cannot operate without its market recognition, which drives customers into its stores. *See, e.g., Inwood Labs, Inc. v. Ives Labs, Inc.*, 456 U.S. 844, 854 (1982)(explaining the relationship of trademarks to goodwill); *Hanover Star Milling Co. v. Metcalf*, 240 U.S. 403 (1915)(same); A*merican Sleek Craft, Inc. v. Nescher*, 131 B.R. 991 (S. Ariz. 1991). The two entities have an interdependence of basic operations. Homer needs Home Depot for virtually all of its royalty income. Homer is not engaged in a separate line of business—it does not buy and license third-party intangible property. Home Depot does not operate under other trade names and trademarks.

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https://portal.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-Z/,DanaInfo=www.mtc.gov+AllocaitonandApportionmentReg.pdf.

Under *Talley*, and under the tests laid out in precedents established by the U.S. Supreme Court, these substantial intercompany transactions involving operationally-critical intangible property are strong evidence that a unitary relationship exists between Homer and Home Depot.

C. Homer's Trademarks are "Embodied in" its Unitary Business Operations with Home Depot and "Delivered to" Home Depot's Customers, Driving Sales at Home Depot Stores

The holding of *Talley* is that centralized administrative services, standing alone, will ordinarily not be sufficient to allow combination of diverse business lines. 893 P.2d at 25. In articulating the basis for that holding, the court announced a distinction between the integration of "core" or "basic" functions of a unitary business, which would ordinarily justify filing of a combined return, and integration of "accessory services." *Id*. The court described "accessory services" to include financing, legal or other "internal services" which were not "embodied in the product or delivered to the customer." *Id*. The value of "accessory services", the court concluded, could be easily quantified, and thus, intercompany charges for providing those services would not be expected to lead to a misstatement of earnings among the entities doing business in the state. 893 P.2d at 26. The court also recognized that where the "accessory services" were "pervasive", a different result might obtain. *Id*.

Not surprisingly, the taxpayer in this appeal now seeks to expand the scope of what is an "accessory" function to encompass what is certainly a "core" function of retailing, the creation and maintenance of goodwill as embodied in trademarks and trade names. (*Opening Brief*, pp. 24-26.) Unlike discrete, internal back-office services, the value of business goodwill cannot be ascertained by reviewing billing rates and service hours. The *Talley* court's emphasis on unitary inputs "embodied or delivered to the customer" has also caused the parties to focus on whether Homer's licensed logos appear on particular products sold to customers. (*Opening Brief*, pp. 26-27.) The focus is misguided because it fundamentally misconstrues the nature of a retail establishment's goodwill embodied by its trademarks and trade names. As set forth in Home Depot's *Annual Report for 2000*, *supra* at pp. 3 and 6, its goodwill arises from and encompasses the entire retail experience:

> Our founders have said it many times. Home Depot has the greatest [sales] associates in the world. We know that Home Depot service, quality and low prices results in the best customer experience in retailing...Every day, we have to earn the trust of our customers....
>
> We have the most recognized brand in home improvement, which gives us the power to extend our Home Depot success into formats that are complementary to our core business.

Home Depot's trade name represents the intrinsic value of those retailing expectations in generating sales. [11] The unitary connection between that goodwill

[11] As noted in the 1991 appraisal, "these trademarks identify Home Depot's operations, products and services. These trademarks are a signal to the consumer of

and Home Depot's retail business is not dependent upon "Home Depot" decals appearing on individual products sold in the stores. The "Home Depot" trade name appears over the entire store, imbuing the entire retail establishment – its products and services – with the "Home Depot" goodwill, an operating intangible acquired from Homer through substantial intercompany licensing transactions.

The 4% of gross sales which Homer now charges to Home Depot as a royalty represents the price which a competitor would pay to be able to offer its customers these same predictably satisfactory retail experiences. It is little wonder that Homer, which inherited the right to license the value of these expectations and receive royalty payments, with none of the associated expenses, purportedly earns more net income than Home Depot itself.

The "embodied in the product or delivered to the customer" concept was carried over in *R.R. Donnelley & Sons Company v. Arizona Department of Revenue*, 224 Ariz. 254, 229 P.3d 266 (App. 2010), which the taxpayer cites in arguing that deliberate income-shifting is permissible under Arizona law. In *R.R. Donnelley*, this court correctly concluded that a Delaware subsidiary, Heritage, which was established to hold and manage the intangible property rights of the taxpayer, a printing business, was engaged in a unitary business with that taxpayer. 224 Ariz. at 261-266, 229 P.3d at 273-277. The central basis for the *Donnelley*'s

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the level of quality and service that is associated with Home Depot." (R.17, Ex. B, page 13.)

court's conclusion was that the intangible property given to Heritage and licensed back to the taxpayer constituted a substantial flow of "operational intangibles" analogous to a flow of goods or materials in a vertically-integrated business, *citing* Hellerstein, *State Taxation*, ¶ 8.09[4][a] (2nd. Ed.). 224 Ariz. at 265, 229 P.3d at 277. The court held that the transfer of intangible property to Heritage was analogous to the transfer of tangible property between related companies which is recognized as a factor suggesting a unitary business relationship in A.A.C. § R15-2D-401(G). *Id.*

The court goes on to note that Heritage's intangible property--the trade names--were "delivered" to the taxpayer's customers by appearing on shipping labels, signage, the company's website and promotional literature. This "delivery" is indistinguishable from the "delivery" of Homer's trademarks in the form of store signage informing customers they were indeed shopping in a Home Depot. Based on the finding that Heritage's trademarks were "delivered to" the taxpayer's customers in the form of advertising and promotional materials, this court concluded that Heritage's intangible property and services were not "accessory functions" but rather were "fully and completely operationally integrated." *Id*. at 262, 274.

Donnelley's holding is directly applicable to this case: all of the intangible assets owned by Homer were transferred to it from Home Depot, and virtually all of those assets were re-licensed back from Homer to Home Depot, creating substantial flows of value. Homer's trademarks are "embodied" in the Home Depot retail establishment and "delivered to" Home Depot's customers in the form of store signs and advertising.

D. A.R.S. § 43-942 is Intended to More Accurately Reflect Earnings Where a Unitary Business is Conducted Through Two or More Business Entities.

The Taxpayer in its *Opening Brief* (pp. 25-28) predictably glosses over the actual holding of *Donnelley* and instead focusses on the several pages of *dicta* which follow that holding. The Commission also addresses that *dicta* because of its concern that the court's comments appear to depart from what should be the proper analysis of the unitary business principle and its relationship to A.R.S. § 43-942.

Although the *Donnelley* court had already concluded that Heritage's trademarks were "operationally integrated" into the unitary business, it then offers that: (a) if the trademark services had been "accessory", and (b), if the trademarks were licensed to third parties in the future, they might not be deemed "'so pervasive as to negate function[al] independ[ence]' of the subsidiary." *Id. at* 258, *quoting Talley*, 893 P.2d at 25.

The Commission suggests that the court's extraneous comments misconstrue the meaning of the *Talley* court's announced "exception" to its rule that the existence of intercompany administrative services such as accounting and payroll services generally should not lead to a unitary finding. *Talley* recognized that even "accessory" services could lead to a unitary finding if the services were so pervasive as to constitute a substantial flow of value. 893 P.2d at 25.

The employment of a trade name representing the goodwill of a company is not similar to centralized accounting, legal, payroll and similar services; it is a "core" operational function of a retail business, to use the court's preferred terminology, not an accessory one. Moreover, the "pervasiveness" of intercompany services (in determining if a unitary relationship is created) should not hinge on whether those services were also offered to third parties.

The *Donnelley* court's suggestion that substantial transactions with third parties might have led to a different result (at least where the trademarks are not "delivered" as an integral part of transactions with customers) came in response to an *amicus* brief filed by the taxpayer in this appeal. *Donnelley* at 276. In that *amicus* brief, Home Depot urged the court to make a distinction between wholly-owned intangible holding companies that deal exclusively with the operating companies, and those which license that intellectual property to third parties on a substantial basis, which it claimed described Homer's operations. *Id*. Not surprisingly, the taxpayer seizes on the court's comments as a reason to distinguish the holding of *Donnelley* from its own circumstances (*Opening Brief*, p. 30), but the argument fails as a matter of fact and as a matter of law.

The argument fails as a matter of fact because 97% of Homer's income comes from re-licensing its marks to Home Depot and another 2% comes from licensing those marks to foreign Home Depot subsidiaries, by no means a third party. (R.22, ¶ 30.) The remaining 1% of Homer's income comes from licensing the use of the marks in non-hardware contexts, including books and toys. (R.17, Levy Decl., p. 3.) This activity does not constitute a separate and discrete line of business, such as buying and re-licensing the intellectual property of third parties. To the extent the *Donnelley* court may have thought that substantial transactions with third parties would ensure an accurate transfer price for the value of a trademark, nothing in this record suggest that Homer licensed the trade names and trademarks in a manner which would allow for such a comparison.

The argument fails as a matter of law on more fundamental grounds. Whether the intellectual property is licensed to others should not alter the analysis of whether there have been substantial intercompany flows of value between Homer and Home Depot, the litmus test for combination under *Talley* and U.S. Supreme Court cases. *See Talley* at 24-25; *Container*, 463 U.S. at 165-6; *Allied Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 783 (1992); *Meadwestvaco Corp. v. Illinois*, 553 U.S. 16, 29 (2008). The original transfer of

Home Depot's goodwill to Homer was a "substantial flow of value" between the entities, even if it did not generate any tax consequences. That flow of value continued through-out these refund years, in the form of Home Depot's continued operational use of the marks to drive business into its stores and Home Depot's annual royalty payments, which varied between $789 million and $2 billion.

The *Donnelley* court's *dicta* could be misconstrued to suggest that in order to create a unitary relationship, there must be both exclusive and two-directional flows of operational goods and services. No court has ever suggested those requirements are necessary to create a unitary relationship. It would be a rare case where a vertically-integrated company would send products one direction and receive anything but payments in return. Nor is it uncommon for components of that unitary business to provide materials or services for third parties; these outside activities should not break the unitary link.[12]

In *Exxon v. Wisconsin*, 447 U.S. 207 (1980), the taxpayer's activities in Wisconsin were limited to retail sales of gasoline, and the particular gasoline sold in that state was not even refined by the taxpayer, yet the Court held that the sales

[12] The problem with the *Donnelley* court's *dicta* can be illustrated by considering a vertically-integrated oil company, a prototypical unitary business enterprise. A subsidiary might produce crude oil in Oklahoma, transport that crude oil in a subsidiary's pipeline and sell that oil to its refining subsidiary in Texas, with the output sold to distributors nationwide. The operational flow of goods goes only in one direction, yet the various entities are engaged in a single unitary operation. The unitary connection is not broken if any or all of the entities also sell some portion of their output to third parties.

were a part of the taxpayer's vertically-integrated oil business. 447 U.S. at 213. There is no principled basis to treat income from licensing intangible property developed by the unitary business to a third party any differently from income from selling tangible products developed by the unitary business to a third party. And in *Allied-Signal*, *supra,* the Court held that income generated from short-term investments of working capital—an asset of the unitary business—was apportionable as part of the unitary business, even though the bank which paid for the use of that asset was not engaged in a unitary relationship with the taxpayer: "We agree that the payee and payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases." 504 U.S. at 787; *Accord*, *Meadwestvaco*, 553 U.S. at 28. At some point a transaction with third parties—customers or suppliers—is required to earn a profit, but the resulting income is not excluded from the apportioned tax base.

The *dicta* in *Donnelley* suggesting that a holding company's licensing transactions with third parties might break the unitary connection is contrary to established law and should not be followed by this court.

The court in *Donnelley* also announced that as a *legal* matter, trade names and trademarks can be separated from an on-going business. 24 Ariz. at 261, 229 P.3d at 271. The taxpayer takes the Tax Court to task for suggesting that these trade names were inseparable from the on-going retail business (*Opening Brief*, p.

15). But the Tax Court's determination was not limited to the legal ownership; the trademarks were inseparable as an *operational* matter, for purposes of determining whether Home Depot and Homer were engaged in a single business enterprise. (R. 36, at 2.) The nature of the particular intangibles at issue here would indeed render them difficult to separate from the on-going business from an economic or operational standpoint. In the leading trademark law treatise, the authors write:

> There is a highly unique legal relationship between trademarks and the good will they come to represent. This relationship is fundamental to the law of trademarks, and several important consequences follow from it. First, a trademark cannot be assigned apart from the good will it symbolizes. Second, **a trademark cannot exist apart from the business in which it is used.** The trademark and good will it represents can thus be said to be inseparable.
>
> Gilson & Green, *Trademark Law and Practice*, ¶ 1.03[7][b] (Lexis/Nexis, 3rd Ed. 2006)(emphasis supplied).

One could pay for the opportunity to put the Home Depot sign in front of a hardware store, but if the operational advantages represented by Home Depot's goodwill were not also included in the bargain, customers would soon catch on and go elsewhere. As the Federal Circuit Court of Appeals noted in *Visa U.S.A., Inc. v. Birmingham Trust National Bank,* 696 F.2d 1371, 1375 (Fed. Cir. 1982), "unlike patents and copyrights, trademarks are not separate property rights. They are integral and inseparable elements of goodwill of the business to which they pertain."

The legal ability to assign ownership of an operational asset like a trade name to another, as noted in *Donnelley*, does not mean that such a separation will produce accurate economic outcomes. *See Container Corporation*, *supra* at 167.[13]

In both the *Talley* and *Donnelley* decisions, this court suggested that "accessory" services performed for diverse business segments generally do not create a unitary relationship, in part because the values of these services can be accurately captured by arms-length accounting. *Talley*, *supra* at 24; *Donnelley*, *supra* at 271. The taxpayer in this case seeks to extend that holding to a "basic" operational function, that is, trademarks representing the value of the goodwill of an on-going business. The Arizona legislature has mandated combined filing of unitary businesses to ensure accurate reflect of income earned by Arizona taxpayers. The court should reject the taxpayer's invitation to allow the selective use of arms-length accounting as a "defense" to combined filing, as it would inevitably lead to more litigation and uncertainty, contravening the legislature's

[13] The federal experience with I.R.C. § 482 "transfer pricing" adjustments at the international level underscores the problems in apportioning profits among related entities using arms-length accounting standards. A recent report by the Congressional Research Service estimates that the inability to determine accurate arms-length transfer prices accounts for approximately half of the estimated \$10-\$60 billion annual federal corporate income "tax gap." As the report notes, "intangibles... tend not to have comparables, and it is very difficult to know the royalty that would be paid in an arms-length price. *Therefore, intangibles represent particular problems for policing transfer pricing."*
Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, *Report No. 4063, p.7* (11/3/10), *available at:* http://assets.opencrs.com/rpts/R40623_20100903.pdf. (emphasis added.)

intent in adopting A.R.S. § 43-942. *See Wal-Mart v. Hinton,* 676 S.E.2d 634 (N.C. App. 2009)(rejecting arms-length accounting as a defense to the state's use of combined filing to establish "true earnings").[14]

E. Combined Reporting is the Appropriate Means to Prevent the Misstatement of the Amount of Home Depot's Income Earned in the State.

In *Talley*, this court emphasized that the "fundamental question" under A.R.S. § 43-942 was whether combined reporting is "necessary to clearly reflect the taxable income earned by those [entities] with Arizona factors." 182 Ariz. at 25, 893 P.2d at 25. Yet certain *dicta* in *Donnelley* pertaining to intangible holding companies indicates a lack of adherence to that principle.

The *Donnelley* court appeared to understand that the establishment of companies such as Heritage (and by extension, Homer), nominally located in low tax jurisdictions, which receive title to and license back trademarks, has the effect of allowing in-state earnings to be shifted outside the state's taxing jurisdiction. The court even quoted Professor Hellerstein's treatise to the effect that such transactions are a "'transparent effort' to 'game' the system," and that "the obvious and appropriate solution to such transparent efforts...is for states to require combined reporting." *Donnelley,* 224 Ariz. at 262-3, 229 P.3d at 274-5, *citing*

[14] It should be noted that no other court has adopted Arizona's distinction between "core" services that become "embodied" in a product or "delivered to" a customer, and "accessory" services that are not. The distinction may prove to be difficult to apply in future cases.

Hellerstein, *State Taxation*, ¶ 9.20.[7][j] (3rd. Ed. 2003). Despite its apparent agreement with Hellerstein's conclusions that the transactions were a "tax avoidance strategy", *id.*, the *Donnelley* court opined that it did not consider preventing tax avoidance an appropriate reason to require combination of intangible holding company income if the tax avoidance was based on "existing rules." *Id*.[15] The Commission suggests that those comments are at odds with the fundamental purpose of A.R.S. § 43-942, which the court had previously addressed in the same opinion:

> We caution, however, that the ability to determine income (and whether an arm's-length negotiation took place) is not the *entire* test to determine whether a business is unitary. *Talley* emphasized that the "fundamental question ... is whether combined reporting ... [is] *necessary to clearly reflect the taxable income earned* by those subsidiaries with Arizona income factors." *Id*. (emphasis added).

Id. at 260, 272.

[15] It should not be assumed that the transactions between Heritage and Donnelley, or Homer and Home Depot, would meet any "existing rules" for recognition of the resulting deductions as an "ordinary and necessary business expense" under I.R.C. § 162. The Arizona Department of Revenue did not challenge the validity of the transactions since such a challenge should be unnecessary under A.R.S. § 43-942. But under the federal tax code, which Arizona uses as its starting point for calculating state income, taxpayers must demonstrate that a transaction has economic substance, specifically, a non-tax business purpose and the intent to meaningfully change the taxpayer's economic position. *See* I.R.C. § 7701(o)(defining economic substance). A transaction that simply moves income from one subsidiary to another would not change the taxpayer's overall economic position.

If the creation of Heritage and the transfer of intangibles to it was a "tax avoidance strategy" designed to "game the system" by shifting R.R. Donnelley's taxable income to Heritage, it follows that combination under A.R.S § 43-942 is the legislatively mandated "obvious and appropriate solution" to address that strategy. *State Taxation*, *supra* at ¶ 9.20. A.R.S. § 43-942 requires combined reporting if the Department determines it is necessary to "clearly reflect" taxable income or "in order to prevent evasion of taxes... " and both clauses are implicated here. Home Depot's trademark transfer strategy has significantly affected its income reporting; the mechanics for such strategies and the states' responses are explained below.

1. Home Depot Shifted Income between Domestic Entities by Transferring Ownership of Income-Producing Assets without Gain Recognition under IRC § 351.

The transactions at issue in this appeal had the effect of understating the measure of Home Depot's taxable income subject to apportionment in the state by shifting an income-producing asset, but not the expense related to that asset, to a newly-created corporation company in a state which does not impose an income tax on intangible income. The income shift was accomplished by means of a one-page contract assigning intangible property rights for which there was no reported consideration. (R.17, Levy Decl. Ex. A, p.1.) The transaction did not generate a taxable gain for either entity under 26 U.S.C.A. § 351 ("I.R.C. § 351"), which eliminates tax on capital contributions to a new domestic entity where a controlling interest in the stock of that domestic entity is received in return.

The federal tax code encourages such stock-for-asset transfers in order to encourage more productive use of capital. *See* Kahn, et. al., *Corporate Income Taxation,* ¶ 7.01, p. 271 (6th. Ed. West 2009). Under the federal system, such transfers generally have no effect on overall tax revenues, because both the asset recipient and the asset transferor will be subject to federal taxation. Under the facts of this case, for instance, the "Delaware" income reported by Homer after the non-recognition transfer will be fully subject to federal tax, offsetting any loss of revenue from Home Depot. In addition, as a practical matter almost all federal taxpayers choose to file returns on a federal consolidated basis under I.R.C. §§ 1501-1502, so the transactions would be subject to elimination on the federal return anyway.

In sharp contrast with the federal treatment of *domestic* asset transfers, when intangible assets are transferred from a domestic corporation to a *foreign* subsidiary (that is, a subsidiary beyond federal taxing jurisdiction), under I.R.C. § 367(d), the transferor is "treated as (i) having sold such property in exchange for payments which are contingent upon the productivity, use or disposition of such property, (ii) and receiving amounts...commensurate with the income attributable to the intangible." I.R.C. § 482 further provides that "[i]n the case of any transfer of intangible property...the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

Beginning in the late 1980's, taxpayers discovered that states using the Internal Revenue Code to determine base income were vulnerable to the effects of I.R.C. § 351 transfers, since the states' taxing jurisdiction did not extend beyond their borders, to Delaware or other low-tax states, and I.R.C. § 367 only applied to true foreign transactions. Assets for which expenses had been deducted during their development could be transferred to affiliates in low tax jurisdictions, without the requirement of reporting deemed income on the cash flows from those assets.

Once the intangible property has been transferred to a separate legal entity like Homer, the stage is set for that entity to charge a considerable royalty amount for the use of that asset. Home Depot's tax return now reflects the effects of a double deduction for the same cost: a deduction for developing the value of trademarks through advertising, building systems, training employees, developing management expertise, and so forth, the value of which is represented by trademarks and trade names, and a second deduction for paying its subsidiary for the right to use those intangible assets.

The states have responded vigorously to this income-shifting strategy. The legislatures of some 24 jurisdictions, including Arizona, have agreed with Professor Hellerstein's conclusion that the "obvious and appropriate" response to income-shifting schemes is the adoption of combined reporting. Combined reporting parallels the operation of the federal consolidated filing system, eliminating the income-shifting effects of inter-corporate transactions among members of the combined group.

Those states which continue to employ separate-entity reporting systems have adopted a number of alternative approaches to eliminate the income-shifting so evident in this appeal. Twenty separate-entity states have recognized that these artificially-created royalty payments are not “ordinary and necessary business expenses” under I.R.C. § 162, and have adopted “add-back” statutes which deny taxpayers a deduction for intercompany royalty and interest payments for intellectual property. *See* Hellerstein, *State Taxation*, ¶ 7.17[3], pp. 7-42-47 (3rd. Ed. 2003); *See also, Surtees v. VFJ Ventures, Inc.*, 8 So.3d 950 (Ala. App. 2008)(upholding use of “add-back” statute to eliminate deduction for royalty payments to Delaware holding company). Some states have attempted to assert that the transactions lack economic substance and should be ignored on that ground. *See, e.g., Syms Corp. v. Comm. of Revenue*, 765 N.E.2d 758 (Mass. 2002)(finding that transfer of trademarks to intangible holding company lacked economic purpose and should not be respected for tax purposes); *Pacificare Health Systems, Inc. v. Oregon Dept. of Revenue,* Oregon Tax Court No. 4762 (2008)(transfer of trademarks and trade names to subsidiary insufficient to justify royalty deduction where parent retained economic control and "tax" ownership).[16] Some states have attempted to assert jurisdiction over the companies holding the intangible property. *See, e.g., Geoffrey v. South Carolina*, 437 S.E.2d 13 (S.C. 1993), *cert. den.*, 510 U.S. 992 (1994); *Kmart Corporation v. Taxation and Revenue Dept.*, 131 P.2d 22 (N.M. 2005); A*&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004).

There are difficulties with all of these approaches that combined reporting is intended to overcome. First, taxpayers can plan around state "intangible property" add-back statutes by changing the types of assets transferred to the out-of-state entity. *See, e.g.*, *Wal-Mart v. Hinton*, 676 S.E.2d 634 (N.C. App. 2009)(ownership of Wal-Mart stores transferred to "captive real estate investment trust" to create artificial rent deduction); *Bridges v. AutoZone Properties*, 876 So.2d 789 (La. App. 2004)(same).

Secondly, taxpayers can try to avoid the application of the sham transaction doctrine by imbuing the transfers with some evidence of a legitimate non-tax purpose. *See, e.g., Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E.2d 504 (Mass. 2002).

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[16]*Available at:* http://www.ojd.state.or.us/Tax/taxdocs.nsf/($All)/CC050B3D00F3B951882574790077E242/$File/Pacificare4762Order.pdf.

And finally, litigation over the scope of the states' authority to tax remote entities is inefficient and the results cannot be guaranteed. *Compare: Scioto Insurance Co. v. Oklahoma Tax Commission*, 279 P.3d 782 (Ok. 2012)(state lacked jurisdiction over captive insurance company receiving indirect franchise fee payments), and *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Ok. Civ. App. 2005)(state had jurisdiction to tax Delaware holding company receiving royalty payments).

Combined filing statutes, properly applied, prevent such income-shifting efforts precisely because a corporation would be very unlikely to transfer true ownership of its core income-producing assets, whether tangible or intangible, to anyone except a closely controlled and integrated ("unitary") subsidiary. In recent years, several states which had tried other means to combat income-shifting strategies have moved to mandatory combined filing because it is viewed as a more predictable and comprehensive solution. *See, e.g.,* Mass. Gen. Laws, Ch. 63, §32B; W.Va. Code § 11-24-13(a); and Wis. Stat. § 71.255.

2. Combination of Homer and Home Depot is Necessary in Order to "Clearly Reflect" the Latter's Earnings in Arizona.

In both the *Talley* and *Donnelley* decisions, this court has emphasized that the *sin qua non* of combined reporting under Arizona's statute is a demonstration that combined reporting is necessary to clearly reflect income. Arizona's regulation providing that the requirement is met whenever two or more entities are engaged in a unitary business, without more, is the correct approach. See A.A.C. § R15-2D-401(A). Where the two entities are entirely operationally inter-dependent as they are in this appeal, nothing more should be required to compel combination.

The taxpayer argues that the *Donnelley* case requires proof of income distortion before combined reporting is allowed, and that it was incumbent upon the Department to rebut the two highly subjective and contradictory appraisals of Home Depot's goodwill values that it commissioned to support its "tax planning." (*Opening Brief*, pp. 18-21.) As the U.S. Supreme Court noted in *Container, supra* at 167, arms-length accounting "is subject to manipulation and imprecision" and cannot be relied upon to produce a "true" picture of where income is generated. And followed to its logical ends, requiring the state to rebut arms-length accounting studies would eviscerate A.R.S. § 43-942 and return Arizona to a separate-entity system. *See* Hellerstein, *State Taxation*, ¶ 8.11[3][c], pp. 8-282-3 (3rd. Ed. 2003)("...evidence of arms-length pricing between related affiliates is of no legal consequence."). But to the extent *dicta* in *Donnelley* could be misconstrued to suggest that evidence of inaccurate results under separate entity reporting is required, the compelling evidence of income distortion in this case bears discussion.

The Supreme Court of Montana has announced a simple test for determining whether combination is necessary in order to clearly reflect income: if the taxpayer's liability to the state would be different if the unitary business was operated under one legal entity versus two or more legal entities, then combination is appropriate. *See Montana Dept. of Revenue v. American Smelting and Refining Company*, 567 P.2d 901, 907 (Mt. 1977); *Accord*, *Coca-Cola Co. v. Department of Revenue*, 533 P.2d 788, 794 (Or. 1975). In the present appeal, the record shows that Home Depot's tax liability to the state on a separate-entity basis is less than half of what its liability would be on a combined basis. (R.22, Ex's. 3, 4 & 5.)

A second approach to demonstrating "distortion" is to compare the amount of factors (expenses) needed to generate a similar amount of income in the unitary entities. A recent case from the New York Tax Tribunal illustrates that approach in the context of that state's "forced" combined filing statute, which allowed taxpayers to avoid combined filing by demonstrating that its transactions met arms-length accounting standards (New York has since moved closer to a mandatory combined filing system). *See In re InterAudi Bank F/K/A Bank Audi (USA),* State of New York Tax Appeals Tribunal Decision DTA No. 821659 (4/14/11).[17] In the *InterAudi Bank* case, the Tax Appeal Tribunal addressed the tax consequences of an I.R.C. § 351 (non-recognition) transfer of portfolio assets to a Delaware subsidiary. The tribunal compared the profits and expenses of the two entities before and after the transfer of the property and concluded that although the

[17] *available at*: http://www.nysdta.org/Decisions/821659.dec.pdf.

transfer was technically at arms-length (because the bank received the entire stock of the subsidiary in exchange for the assets), the transaction distorted the bank's income, requiring combination. The tribunal noted that the operating bank retained the expenses of conducting the banking business (principally interest expense) while the Delaware subsidiary reaped the profits of the "investment portfolio" transferred to it. The tribunal noted that the investment subsidiary had expenses equaling just 1% of profits, while the operating company's expenses increased from 81% of profits to 96% of profits subsequent to the "investment portfolio" asset transfer.

In the present appeal, Homer and Home Depot have even more skewed ratios of income to expenses following the transfer of Home Depot's trade names to Homer. Homer has just four employees who allegedly generated $789 million, $1.781 billion and $2.034 billion in the 2000-2002 fiscal years, while Home Depot's 237,300 employees earned only $1.739 billion, $0.962 billion and $1.073 billion during the same periods. Put another way, for the FYE 2/30/02 period, Home Depot realized a profit of just $4,524 for each of its employees, while Homer earned a profit of $508,553,213 for each of its employees. This strongly suggests that the incomes of these entities are not properly aligned with the expenses necessary to generate that income.

In an analogous situation, this court determined that inclusion of the "gross" amount of overnight treasury sales in a taxpayer's apportionment formula distorted the amount of income generated in Arizona, since the overnight treasury sales added millions of dollars to the "everywhere" portion of the sales apportionment factor while generating very little actual income, which had the effect of understating the income generated from the taxpayer's in-state retail operations. *Walgreen Arizona Drug Co. v. Arizona Dept. of Revenue*, 209 Ariz. 71, 73, 97 P.3d 896, 898 (App. 2004); *Accord, Microsoft v. Franchise Tax Board*, 47 Cal. Rptr. 3d 216, 139 P.3d 1169 (2006).

Another approach for gauging whether Home Depot's income in Arizona can be accurately stated without combination of Homer's income is to consider the source of Homer's earnings. The system of formulary apportionment used in Arizona and every other state that imposes a corporate-based system of taxation is designed to approximate where and how income is earned. *Container* at 165. Formulary apportionment principles are applicable whether a unitary business is carried out in one legal entity or across entity lines. *See, e.g., Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924)(rejecting claim that distribution subsidiary's profits could be determined separately from overseas' manufacturing operations).

The test for any apportionment system is whether it has attributed a "grossly distorted amount" of income to a particular state relative to the taxpayer's activity in that state. *Norfolk & Western Railway v. State Tax Commission*, 390 U.S. 317, 329 (1968). Attributing more than two billion dollars of income in FYE 2002 to a Delaware office space housing four employees, while attributing slightly over one billion of income to the location of Home Depot's 1,134 stores, is not reflective of where and how the unitary enterprise earned its income. Homer's income did not really arise in Delaware, yet that is what the taxpayer in this appeal must argue in order to claim that Home Depot's Arizona income is not misstated.

The source of the income from Homer's intangible property was not in Delaware, because the value of intangible property like trademarks is inextricably connected to the underlying business activity which is represented by the asset. In the seminal case of *Adams Express Company v. Ohio*, 165 U.S. 194 (1897), the Supreme Court held that the value of goodwill could not be isolated from the location of the taxpayer's operations for purposes of property tax apportionment. Regarding the "location" of an interstate railroad's goodwill, the Court wrote:

> [i]s it simply where the home office is, where is found the central directing thought which controls the workings of the great machine, or in the State which gave it its corporate franchise, or is that intangible property distributed wherever it is located and its work is done? Clearly, we think the latter.

165 U.S. at 223-224.

Accord, Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936)(intangible property acquires a taxable business situs where employed); *Curry v. McCanless*, 307 U.S. 357 (1939(same).

Manifestly, the source of Homer's income is not the activities of its four employees in Delaware, but rather the operations of Home Depot. Because the legal ownership of those assets has been transferred to Homer, combination is required to accurately reflect where the unitary business generates its income. *Cf.*, W. Hellerstein, *State Taxation of Corporate Income from Intangibles*, TAX MGMT. MULTISTATE TAX PORTFOLIO, p. 57, n.531, (BNA 1996)("To suggest that the geographical location of the intangible property (and the income it produces) follows the location of investment managers is to let a very small tail wag a very large dog.").

In sum, even if direct evidence were required that Home Depot's earnings were misstated on a separate entity basis, that evidence is present in this case.

F. "Operational Unity" is Not Limited to Similar Activities of Personnel—it Extends to Operational Assets Used in the Unitary Business.

The taxpayer argues that there is no "operational unity" between Homer and Home Depot because the two businesses are engaged in separate lines of business, listing such facts as differing bank accounts, separate officers and directors and different day-to-day operations, noting for instance that Homer never operated hardware stores. (*Opening Brief*, pp. 11-12, 21-24). As set forth above, the Commission believes that the facts in the case demonstrate that both entities are engaged in a single vertically-integrated business and thus are entirely "operationally-connected." Homer is not engaged in a separate business; most importantly, it does not buy intangible property licenses from third parties and does not license Home Depot's trade names to competitors.

But even if the "operational" connection between Homer and Home Depot were in doubt because the employees of the two entities perform dissimilar functions, the law is now well-established that separate entities are subject to combination if they hold operational *assets* belonging to the unitary business, even if those entities have no operations at all. In *Blue Bell Creameries, L.P. v. Roberts*, 333 S.W.3d 59 (Tn. 2011), the taxpayer alleged that a capital gain recognized by a holding company from the sale of operating company's stock could not be apportioned by Tennessee, because the holding company had no employees or operations, and thus could not be unitary with the in-state taxpayer, a manufacturer of ice cream. The Tennessee Supreme Court sharply disagreed, writing:

> It is uncontested that BBC USA is a separate business entity from Taxpayer. To determine whether two separate business entities form a unitary business, we must look beyond the superficial divisions between parent corporations and their subsidiaries to the "underlying activity" generating the income. *See Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 440–41, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980). To be an unrelated business activity, the separate business entity must constitute a "discrete

business enterprise" from the taxpayer. *Exxon Corp.*, 447 U.S. at 223–24, 100 S.Ct. 2109.

For Taxpayer and BBC USA, the only underlying activity generating income is the production, sale, and distribution of Blue Bell ice cream. BBC USA may be a separate business entity, but it is uncontested that BBC USA does not conduct any business operations of its own. …Because both entities derive their income from a single underlying activity, we hold that BBC USA is unitary with Taxpayer's Blue Bell ice cream business.

333 S.W.2d at 71.

In the present case, as in *Blue Bell*, combination is appropriate where both entities derive their income from "a single underlying activity" which is in this case is the home improvement retail business. *Accord,* Arizona D.O.R. Ruling No. 200600091-C (9/8/08).[18]

So too, in *Appeal of PBS Building Systems, Inc., and PHK Building Systems, Inc.*, 1994 Cal. Tax LEXIS 434, 94-SBE-008 (11/17/94), the California State Board of Equalization (SBE) held that a "pure" operating company should be deemed unitary with the holding company which held its stock because of significant flows of value and contributions and dependencies in the form of shared tax advantages and loan guarantees. *Accord, Appeal of Gad Rad West, Inc*., 94A-SBE-0240, 1996 WL 767612 (1996); *Hugo Neu-Proler Int'l Sales Corp.* v. *California Franchise Tax Bd.*, 195 Cal. App.3d 326 (Cal. App. 2[nd.] Dis. 1987).

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[18]*Available at*: http://www.azdor.gov/LinkClick.aspx?fileticket=XoBWOu7kk5o%3d&tabid=105&mid=474.

The suggestion that income can be shielded from Arizona's combined reporting requirement by placing ownership of unitary assets in a non-operational or diverse entity misconstrues Arizona's laws. Under A.A.C. R15-2D-401(B), combination is required for those entities, or components of business entities, engaged in a unitary business. Even if the court were to determine that Homer's *de minimis* third-party licensing activities were not part of the unitary business, the 99% of Homer's income that derives directly from transactions with unitary affiliates should still be subject to inclusion on a combined report.

Homer's intangible assets and trademark protection activities of its four employees are an integral part of Home Depot's retail business; separating those assets and functions into a separate subsidiary does not make them less integral to Home Depot's business.

CONCLUSION

Amicus Multistate Tax Commission urges the court to uphold the finding of the Tax Court requiring Homer and Home Depot to file a combined report in order to clearly reflect the income of Home Depot generated in Arizona.

Respectfully Submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Ariz. R. Civ. App. Pro. 14(b), I certify that the attached brief uses proportionately spaced type of 14 points, is double-spaced using a roman font, and contains ______ words, which is an average of ____ per page, both of which comply with Rule 14(b).

DATED October 12, 2012.

____

Bruce J. Fort

RULE 15 CERTIFICATE

Pursuant to Ariz. R. Civ. App. Pro. 4 and 15(d) and Arizona Supreme Court Administrative Order No. 2012-2, undersigned counsel hereby certifies that, on this date, the original of the Appellants' Opening Brief was e-filed using AZTurboCourt with the Court of Appeals, Division One. No copies were submitted pursuant to instructions of the Clerk of the Court of Appeals, Division One.

DATED October 12, 2012.

Bruce J. Fort

CERTIFICATE OF SERVICE

On this date, ___ copies of the *Amicus Curiae* Brief of the Multistate Tax Commission were delivered to the United States Postal Service and addressed to counsel listed below, bearing appropriate postage for First Class Mail:

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