

Arizona – Goodwill receipts excluded from sales factor

September 5, 2013

In brief

The Arizona Department of Revenue found that a taxpayer's receipts attributable to goodwill in a deemed asset sale qualified for exclusion from the sales factor as substantial amounts of gross receipts arising from an incidental or occasional sale. The Department reasoned that Arizona's regulation addressing occasional sales of fixed assets should be applied to revenue from intangible property, like goodwill.

[[Arizona DOR Hearing Office Decision No. 201200235-C \(5/31/2013\)](#)]

In detail

Facts

Taxpayer designed, manufactured, and installed products and integrated solutions and services. In 2006 Taxpayer's parent company sold its stock in Taxpayer to an unaffiliated third party. The parties elected to treat the stock sale as a deemed asset sale under the Internal Revenue Code. The purchase price for Taxpayer's assets included goodwill. Taxpayer appealed a decision by the Department's Audit Section that receipts attributable to goodwill should be excluded from the sales factor.

Gain on sale of goodwill constitutes business income

On appeal to the Department's Hearing Office, the Department first examined whether Taxpayer's receipts from its

deemed asset sale, including goodwill, was business or nonbusiness income. The Department recognized that goodwill is a by-product of good business operations, which is built over a time and does not arise independent of Taxpayer's business operations. The Department contrasted goodwill from other intangible assets such as stocks or bonds, which may exist independent of an entity's business operations. The Department acknowledged that goodwill is "inseparable from the business as a whole" and found that receipts attributable to the sale of goodwill constitute business income.

Receipts from sale of goodwill qualify for sales factor exclusion

Arizona's Administrative Code provides that the sales factor excludes substantial amounts of gross receipts that arise from an

incidental or occasional sale of a *fixed asset* used in the regular course of the taxpayer's trade or business, such as a factory or plant. The Code is silent regarding similar receipts arising from a sale of intangible property, such as goodwill.

For guidance, the Department looked to California FTB Legal Ruling 97-1, which addressed a similar issue. In that ruling, California recognized that its sales factor exclusion for receipts from a fixed asset occasional sale is based on the rationale that such receipts do not fairly reflect the taxpayer's day-to-day business activity and therefore cause excessive income to be apportioned to the state where the occasional sale took place. California reasoned that there is "no logical basis for distinguishing between fixed assets and intangibles" and, therefore, applied the same

rationale to revenue from the sale of intangible property. As a result, the Legal Ruling allowed gross receipts from the sale of intangible property to qualify under the state's occasional sale exemption.

The Department found that the California FTB Legal Ruling was 'legally sound and persuasive.' Accordingly, the Department found that Taxpayer's gross receipts from its deemed sale of its assets, including goodwill, was not a transaction in the

regular course of its trade or business and therefore such receipts should be excluded from Taxpayer's sales factor.

The takeaway

The Arizona regulatory provision excluding receipts from occasional sales is the standard MTC language adopted by a majority of UDITPA states. There is a long history across the states regarding whether an occasional sale of *intangibles* can or should be excluded notwithstanding a regulation's specific reference to 'fixed

assets.' This continued to be a controversial issue in California following FTB Legal Ruling 97-1, leading California to ultimately amend its regulations prospectively in 2002 to specifically exclude occasional sales of *both* fixed assets and intangibles. It will be interesting to see whether the Hearing Officer's decision adopting the rationale of FTB Legal Ruling 97-1 proves to be the last word on this issue for Arizona purposes.

Let's talk

If you have questions about the Department's ruling, please contact:

State and Local Tax Services

Robert A Garvey
Principal, *San Diego*
+1 (858) 677-2536
robert.a.garvey@us.pwc.com

Monica Hoyt
Director, *San Diego*
+1 (858) 677-2486
monica.hoyt@us.pwc.com