

SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

TX 2006-050001

09/21/2007

HON. THOMAS DUNEVANT, III

CLERK OF THE COURT
S. Brown
Deputy

ARIZONA STATE DEPARTMENT OF
REVENUE

KIMBERLY J CYGAN

v.

CENTRAL NEWSPAPERS INC, et al.

PATRICK DERDENGER

UNDER ADVISEMENT RULING

(Plaintiff's Motion For Summary Judgment and Defendant's Cross-Motion For Summary Judgment)

The undisputed facts are these: Until 1998, Central Newspapers, Inc. (CNI) and several related corporations owned and operated a Washington state partnership, Ponderay Newsprint Company, which sold newsprint to, among others, CNI's Arizona newspapers. Ponderay was not deemed part of the single taxpayer filing a consolidated return in Arizona for those years. In 2002, following an audit, the Department determined that CNI's imputed profit from Ponderay was taxable income. The Board of Tax Appeals ruled in CNI's favor. The Department filed this appeal.

It is significant to the analysis that Ponderay was a partnership. Partnership income is taxed to an Arizona domiciled partner in accordance with A.R.S. § 43-1412. Under that statute, the partner's distributive share of the partnership's profits is imputed to him and taxed, regardless of whether a distribution is in fact made. Thus, the tax being levied in this case is a tax on CNI on the profit attributable to Arizona that it earned from its investment in Ponderay. It is not a tax on Ponderay, any more than a tax on an investor who owns shares in General Motors is a tax on General Motors.

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Defendant contends that the separate status of Ponderay, in conjunction with 15 U.S.C. § 381(a), prevents the taxation of its profits at least until and unless there is a distribution to an Arizona taxpaying entity. This is not supported by either state or federal law. Arizona law treats a partnership as a separate entity for many purposes, but as a mere conduit for the obligation to pay tax on partnership profits. *Arizona Tractor Co. v. Arizona State Tax Commission*, 115 Ariz. 602, 605 (App. 1977) (quoting *United States v. Basye*, 410 U.S. 441, 448 n.8 (1973)). 15 U.S.C. § 381(a) does not bar the state from sourcing Ponderay's sales to Arizona in order to compute CNI's taxable income. The statute provides, "No State ... shall have power to impose ... a net income tax on the income derived within such State by any person from interstate commerce" under the conditions so exhaustively detailed in the parties' briefs. Thus, Arizona may not tax Ponderay on Ponderay's income. However, subsection (b) goes on to say that subsection (a) does not apply to a person or corporation domiciled in the taxing state. Subsection (b) governs here: the state is taxing the income earned by CNI, a corporation domiciled in Arizona, on the income it is deemed to have realized from its investment in Ponderay. Neither the federal statute nor *Basye* requires that Ponderay be treated as a separate entity. *Basye* interpreted the Internal Revenue Code, not Section 381(a), and did not indicate that state statutes imputing a distribution of profits from an out-of-state subsidiary to an in-state owner are prohibited by the federal law.

Defendant's position on the applicable fraction is logically contradictory. On the one hand, Ponderay's sales are not to be included in the numerator. On the other hand, they are to be used in the denominator to *reduce* the tax, not only on CNI's income from Ponderay, but on its non-Ponderay income. This outcome is disfavored. A.R.S. § 43-903(A) provides that, unless permitted accounting rules yield a different result, all items of gross income are to be included for the taxable year in which received (or imputed to be received) by the taxpayer. To the extent that Ponderay's sales are relevant to the calculation of CNI's gross Arizona income, they are properly included in the numerator. CNI does not claim that Ponderay's profits are not relevant, only that 15 U.S.C. § 381(a) prohibits their inclusion. But that statute holds only that Arizona may not tax Ponderay's income. It is silent about including Ponderay's sales in the calculation of CNI's taxable income. *National Private Truck Council, Inc. v. Commissioner*, 688 N.E.2d 936 (Mass. 1997), is inapposite: that case dealt with direct taxation of the profits of an out-of-state entity, not, as here, taxation of the in-state owner on profits it earned from its out-of-state subsidiary.

Therefore, IT IS ORDERED granting Plaintiff's Motion For Summary Judgment and denying Defendant's Motion for Summary Judgment.