BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	**DECISION OF HEARING OFFICER**
[REDACTED]	)	
	)	**Case No. 200600105-C**
FEIN [REDACTED]	)	

A hearing was held on November 6, 2006 in the matter of the protest of [REDACTED] (Taxpayer) to an assessment of corporate income tax and interest by the Corporate Audit Section (Section) of the Arizona Department of Revenue (Department) for tax years 1986 through 1993. Taxpayer's opening post-hearing memorandum was timely filed on January 5, 2007. The Section's response post-hearing memorandum was timely filed on February 5, 2007. Taxpayer's reply post-hearing memorandum was timely filed on March 2, 2007. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

The evidence and the parties' joint listing of facts establish the following. During the audit period, 1986 through 1993, [REDACTED] was a wholly owned subsidiary of Taxpayer. In 1975, [REDACTED] submitted a request to the Department to change its method of accounting for tax reporting from accrual to the completed contract method. During this same time period, [REDACTED] and the State of California granted [REDACTED] the same request. However, the Department denied [REDACTED]'s request. In response, [REDACTED] filed a claim for refund for certain years using the completed contract method of accounting. As the Department did not respond to the refund claim within six

months, [REDACTED] treated the refund claim as denied and appealed the denial to the Arizona Board of Tax Appeals. Before any hearing was held before the Board, [REDACTED] and the Department reached a settlement of the appeal and entered into a Closing Agreement (Agreement) in [REDACTED], 1981 that allowed [REDACTED] to use the completed contract method of accounting for long-term contracts and income tax apportionment. The Agreement addressed calendar years 1974 through 1978 and [REDACTED]'s method of accounting and income tax apportionment for subsequent years. The Agreement provides in pertinent part:

> **4. The parties agree that in years subsequent to 1978 [REDACTED] shall report to the State of Arizona using the completed contract method of accounting and an apportionment method for completed contracts substantially similar to that used in California, *until such time as a different method of accounting or apportionment shall be approved by the Department on taxpayer's request or required by the Department under applicable law.***
>
> **5. This agreement is final and conclusive except:**
> **(a) As specifically provided hereinabove;**
> **(b) The matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of material facts.**
> **(c) *If it relates to a taxable period ending after the date of this agreement, it is subject to any law, enacted after the agreement date that applies to that taxable period.* (Emphasis added.)**

[REDACTED] acquired [REDACTED] in 1985. [REDACTED] remained a subsidiary of [REDACTED] throughout the audit period. [REDACTED] originally filed separate company returns to Arizona

for 1986 through 1992 using the completed contract methodology pursuant to the Agreement.

On [REDACTED], 1994 Taxpayer elected to file retroactive consolidated returns to Arizona pursuant to newly amended A.R.S. § 43-947 (S.B. 1120) for 1986 through 1992. Taxpayer filed its original 1993 Arizona return on a consolidated basis. Taxpayer incorporated the apportionment factors for [REDACTED] in its consolidated Arizona returns but did not use the completed contract method of apportionment provided for in the Agreement.

The Section audited Taxpayer. On [REDACTED], 2000 the Section issued a notice of proposed assessment to Taxpayer for tax years ending December 31, 1986 through December 31, 1993. The majority of the assessment resulted from reinstating the completed contract methodology set forth in the Agreement. Taxpayer timely protested the assessment. On [REDACTED], 2004 the Section issued its third modified assessment. On [REDACTED], 2006 Taxpayer and the Section executed a partial closing agreement covering the audit period. The partial closing agreement closed all issues except for the completed contract issue. The Section's audit apportioned [REDACTED]'s completed contract income to Arizona using the methodology provided in the Agreement. The completed contract issue is the only issue remaining from Taxpayer's protest and before the Hearing Office. This issue concerns the method of apportioning the income of [REDACTED].

Taxpayer's position is summarized in the Conclusion portion of its opening post-hearing memorandum at page 10, which states:

> **The Agreement specifically states that [REDACTED] will continue to [sic] the Method until the respective law on point requires a different method of apportionment. Twice since the Agreement was executed in 1981, the law has so changed. Both the Arizona UDITPA and the amendments to A.R.S. § 43-947 do not allow for use of the Method. It is, in fact, quite clear based on the MTC and California law that there is no provision in UDITPA for the Method unless a specific, supplemental regulation is passed, which has never been enacted in Arizona.**
>
> **Accordingly, [REDACTED] can no longer use the Method under the terms of the Agreement, [REDACTED] was justified in not using the Method for [REDACTED] in its 1986 through 1993 amended filings and the Department's assessment reinstating the Method must be abated.**

The Section argues that the Agreement is still valid and enforceable per the language of the Agreement because neither Arizona's subsequent enactment of the Uniform Division of Income for Tax Purposes Act (UDITPA) nor the 1994 amendments to A.R.S. § 43-947 require the Department not to use the completed contract method set forth in the Agreement. In the alternative, the Section argues that A.R.S. § 43-1148.A.4 applies in the present case since the standard three-factor formula does not fairly represent Taxpayer's business activity in Arizona. Therefore, the Section argues, the method set forth in the Agreement should continue to be used.

In its response post-hearing memorandum, the Section set forth a brief history of the completed contract method of accounting, which history may be summarized as follows. Prior to July 10, 1989, the IRS allowed income from long-term

contracts to be reported under the completed contract method. Under this method, all expenses are deferred until the tax year in which the contract is complete and the income is reported. Effective July 10, 1989, the IRS went to a percentage of completion method of accounting to more accurately reflect income and expenses as earned and incurred. Under the percentage of completion method of accounting, income is reported annually based on the percentage the contract is complete. The IRS "grandfathered" the contracts that were in existence prior to the date of change in recognition of the difficulty in converting methods of reporting income on existing contracts. Therefore, all new contracts were under the percentage of completion method and the older contracts continued to be reported under the completed contract method.

CONCLUSIONS OF LAW

With regard to closing agreements, A.R.S. § 42-1113 provides:

> **The department or any person authorized in writing by the department may enter into a written agreement with a taxpayer relating to the liability of the taxpayer, or relating to the liability of the person or estate for whom he acts, in respect of any tax administered pursuant to this article for any taxable period. *If an agreement is approved by the department within the time stated in the agreement, or later agreed to, it is final and conclusive, except on a showing of fraud, malfeasance or misrepresentation of a material fact. The case shall not be reopened as to the matters agreed on or the agreement modified by any officer, employee or agent of this state. In any suit, action or proceeding, the***

> ***agreement, or any determination, assessment, collection, payment, abatement, refund or credit made pursuant to the agreement, shall not be annulled, modified, set aside or disregarded.*** **(Emphasis added.)**

Former A.R.S. § 43-231, which was in effect when the Agreement was executed in 1981, is basically the same as current A.R.S. § 42-1113. Both statutes provide that a closing agreement is "final and conclusive" except on "a showing of fraud, malfeasance or misrepresentation of a material fact." There has been no showing of fraud, malfeasance or misrepresentation of a material fact in the present case.

As previously noted, the Agreement provides that for years subsequent to 1978, [REDACTED] shall report to Arizona using the completed contract method of accounting and an apportionment method for completed contracts substantially similar to that used in California until such time as a different method of accounting or apportionment shall be approved by the Department on [REDACTED]'s request or required by the Department under applicable law. The Agreement also provides that with regard to a taxable period ending after the date of the Agreement, the Agreement "is subject to any law, enacted after the agreement date that applies to that taxable period." Taxpayer argues that because of the adoption of UDITPA effective in 1984 and the enactment of S.B. 1120 in 1994, both of which do not provide for use of the completed contract method, there has been a change in the law and [REDACTED] can no longer use the completed contract provisions of the Agreement. In support of its position,

Taxpayer cites *General Motors Corporation v. Arizona Department of Revenue*, 189 Ariz. 86, 938 P.2d 481 (App. 1996).

In *General Motors*, the Court's determination rested on the fact that there was a significant change in the Department's regulation concerning the sales factor between the time the agreement between the taxpayer and the Arizona State Tax Commission, the Department's predecessor, was executed and the years under audit in that case. The Court noted at page 95 that "[t]he agreement differs significantly from DOR's current regulation." In the present case, the parties agreed at the hearing that at the time the Agreement was executed, Arizona had no specific provision regarding the completed contract method for the sales factor of the apportionment ratio. Arizona currently has no specific provision regarding the completed contract method for the sales factor of the apportionment ratio. Clearly, there has been no change in Arizona law regarding the completed contract method for the sales factor of the apportionment ratio since the Agreement was executed. Arizona had no specific provision then and Arizona has no specific provision now. Unlike in *General Motors*, the specific Arizona law has not changed in the present case. Therefore, the completed contract provisions of the Agreement still apply and [REDACTED] and the Department are bound by those provisions. In light of this conclusion, it is not necessary to address the parties' other arguments.

Based on the foregoing, Taxpayer's protest is denied.

DATED this 7th day of March, 2007.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by certified mail to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Audit Section