In Donnelley, Arizona Supreme Court Continues Support of State's Unique Approach to Defining a 'Unitary Business'

BY BARB DICKERSON AND KRISTA HOWARD

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Unitary Business

The Arizona Supreme Court recently denied review in *R.R. Donnelley & Sons Co. v. Arizona Dept. of Rev.*, thus making final a lower court decision that reinforces the state's unique legal framework for unitary business determinations. In this article, authors Barb Dickerson and Krista Howard of Deloitte Tax LLP explore the evolution of Arizona's unitary analysis from the state's adoption of its initial unitary rule in 1986, through a series of court decisions that interpreted the rule, and analyze how the Donnelley decision follows the principles set forth in those earlier decisions.

In *Donnelley*, Arizona Supreme Court Continues Support Of State's Unique Approach to Defining a 'Unitary Business'

BY BARB DICKERSON AND KRISTA HOWARD

Barb Dickerson is a tax director and Krista Howard is a senior manager in Deloitte Tax LLP's Multistate Tax Practice, in the firm's Phoenix office. They can be reached at, respectively, bdickerson@deloitte.com and krhoward@deloitte.com. The authors give special thanks to Alfred Paladino and Michael Santoro in Deloitte LLP's Washington National Tax Practice, for their counsel and editing in the preparation of this article.

Arizona's legal framework for unitary reporting is unique in that shared, significant flows of value are insufficient in characterizing a unitary business. Even a group of corporations in the same line of business may not have sufficient unity. Under Arizona's combined reporting rules, the basic operations of each member of a combined group must be analyzed to determine whether each entity is operationally integrated. The analysis generally comes down to whether an entity performs an accessory function or a function that is operationally interdependent with other members at the revenue producing level.

The Arizona Supreme Court recently denied review in *R.R. Donnelley & Sons Co. v. Arizona Dept. of Rev.*,[1] thus making final the Arizona Court of Appeals decision that reinforced the state's unique unitary standards. In *R.R. Donnelley*, the appellate court concluded that true

[1] *R.R. Donnelley & Sons Co. v. Arizona Dept. of Rev.*, 224 Ariz. 254 (Ariz. Ct. App. 2010), *rev. denied*, No. CV-10-0223-PR (Ariz. Nov. 30, 2010).

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operational integration beyond administrative and accessory functions was required.

Arizona's legal framework for unitary reporting is unique in that shared, significant flows of value are insufficient in characterizing a unitary business.

This article explores the evolution of Arizona's unitary analysis. First, we detail the inception of Arizona's unitary concepts from the state's 1986 rule. Then, we review the first Arizona appellate court decision to address this issue, namely, *Arizona v. Talley Indus. Inc.*[2] The 1994 decision in *Talley* followed many of the concepts found in the 1986 rule. The case detailed the elements of Arizona's unitary analysis, even though the tax year at issue, 1983, predated the adoption of the rule. We also review an unpublished decision by the Arizona Court of Appeals[3] that applied Arizona's unitary rules to corporate members that were more in the same line of business than the Talley group of entities, as well as a second unpublished decision by the Arizona Court of Appeals that addresses the flow of unity through a partnership.[4] Finally, we provide a summary of the 2010 *R.R. Donnelley* decision and analyze how it followed the principles of the 1986 rule and the *Talley* decision.

ARIZONA'S EVOLUTION OF A UNITARY BUSINESS

Arizona Statutory Law

At the time of the *Talley* decision, Arizona law addressed the unitary reporting concept in two statutory provisions. Arizona Rev. Stat. §43-942 provided that:

> 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 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. 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.*[5]

Additionally, Ariz. Rev. Stat. §43-947(A) provided that:

> In the case of a corporation liable to report under this title owning or controlling, either directly or indirectly, another corporation or corporations and in the case of a corporation liable to report under this title and owned or controlled, either directly or indirectly, by another corporation, *the department may require a consolidated report showing the combined taxable income or other such facts as it deems necessary. The department may, in such a manner as it may determine, assess the tax against either of the corporations whose taxable income is involved in the report upon the basis of the combined entire taxable income and such other information as it may possess or it may adjust the tax in such other manner as it shall determine to be equitable if it determines it to be necessary in order to prevent evasion of taxes or to clearly reflect the taxable income earned by such corporation or corporations from business done in this state.*[6]

These two statutes provided the statutory authorization to the Arizona Department of Revenue to use the combined method of filing.[7] As a result, by including combined reporting within the authority of the department, the Arizona Legislature effectively conveyed the responsibility to interpret when taxable income needs to be ''clearly reflected'' through the application of combined reporting.

Unitary Rulemaking

In 1981, the department revised its corporate allocation rule under Ariz. Admin. Code §R15-2-1141 and provided limited guidelines for filing combined returns. That rule emphasized that combined reporting would only be allowed when the department determined that the filing was necessary to properly reflect income.[8] The rule contrasted the use of separate accounting versus the ''apportionment method.'' While technically applicable to both single corporate taxpayers and a group of integrated corporations, the principles underlying

[2] *Arizona v. Talley Indus. Inc.*, 893 P.2d 17 (Ariz. Ct. App. 1994).

[3] *F.W. Woolworth Corp./Kinney Shoe Corp./Kinney Svc. Corp. v. Arizona*, Ariz. App. Ct. No. 1 CA-TX 97-0007 (Dec. 11, 1997), *cert. denied*, 1998 Ariz. LEXIS 693, CV-98-0095-PR (Ariz. Sept. 19, 1998).

[4] *Phoenix Newspapers Inc. v. Arizona Dept. of Rev.*, Arizona Ct. App., No. 1 CA-TX 04-0014, 2005 Ariz. App. LEXIS 175 (Dec. 6, 2005).

[5] Ariz. Rev. Stat. §43-942 (emphasis added).

[6] Ariz. Rev. Stat. §43-947(A) (emphasis added).

[7] In 1994, the Arizona Legislature revamped Ariz. Rev. Stat. §43-947 to provide for elective consolidated filing. Laws 1994, Ch. 41, §26. The purpose of the amendment was to provide a defined filing methodology that mirrored both the federal consolidated return methodology and the corporate affiliates included in the return. The election must be made on a timely filed return, and all affiliated entities must give consent in the year of election. The election is binding until the Department of Revenue grants permission to deconsolidate, there is an ownership change that causes a new election to be made at the federal level, or there is a federal deconsolidation. Unlike combined filing in Arizona, a valid consolidated election provides certainty as to the composition of the group for taxpayers. In the original enactment, the session law provided a limited opportunity for taxpayers to make retroactive consolidated elections for tax years 1986 through 1992 to overcome uncertainty about the proper approach to combined filing in the state.

[8] Former Ariz. Admin. Code §R15-2-1141(A)(8)(c).

the use of the ''apportionment method'' were also viewed as requirements for combined reporting. The rule permitted separate accounting when the nature of the business permitted, and allowed the ''apportionment method'' only when the operations of the business were integrated to such an extent that ''true income'' could not be separately computed.[9] The rule offered only limited guidance relative to when the integration of business operations was sufficient to require the use of the apportionment method. For example, it stated that centralized management, financing, accounting, purchasing, or overhead functions by a home office were not ''by themselves'' sufficient basis for precluding separate accounting. It was this rule that the *Talley* court interpreted and clarified.

The tax year at issue in *Talley* was 1983. In that same year, the Arizona Legislature adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), effective for tax years beginning from and after Dec. 31, 1983.[10] The adoption of UDITPA was an initiative of the department, as was the adoption, with few changes, of the model UDITPA regulations established by the Multistate Tax Commission. The exceptions were:

- language deemed necessary at the time to implement Arizona water's-edge limitation, and
- Arizona's unitary test, as discussed below.

To interpret the newly adopted UDITPA legislation, Arizona implemented a comprehensive revision of its corporate income tax rules. Adopted in 1986, Ariz. Admin. Code §R15-2-1131 provided the framework for Arizona's unitary test that is essentially still in place today.[11] This rule established, for the first time, a detailed explanation of Arizona's unitary criteria. In a major change, the rule also required that a combined return be filed if the unitary test was met, a clear departure from the separate accounting preference of the rule it replaced.

Under former Ariz. Admin. Code §R15-2-1131, the activities of affiliated taxpayers would generally be considered a single unitary business if there is evidence to indicate that the basic operations of the components under consideration are integrated and interdependent. As a threshold requirement, the following three factors must be present in order for a unitary operation to exist:

- the entities must be united by a bond of direct or indirect ownership or control of more than 50 percent of the voting stock,
- there must be common management of the component parts or entities, and
- the entities must have reconciled accounting systems.

The rule stresses that the presence of these three items is not sufficient for a unitary business without evidence of *actual and substantial operational integration and interdependence.* For manufacturers, a substantial transfer of material, products, goods, technological data, processes, machinery, and equipment between the entities is required.[12] For service enterprises there must be involvement with the central office of the parent in delivering substantially the same service.[13] The rule provides that there is usually an exchange of employees among the component parts and centralized training of employees.[14]

The rule also provides some guidance regarding factors that will *not* result in a unitary business among entities. For example, centralized top-level management, financing, accounting, insurance, and benefit programs, or overhead functions are not sufficient to establish the required substantial integration. Note also that a conglomerate composed of diverse businesses is not a single unitary business unless operational integration independently exists. As noted in *Talley*, the cost of such *centralized services and functions* performed by the parent corporation for diverse subsidiaries is quantifiable and may be specifically allocated to the respective subsidiaries, rather than serving as a basis for a finding of a unitary business.

Note that the rule underwent changes in 2000, primarily to remove the water's-edge limitation language, and was reorganized and renumbered as Ariz. Admin. Code §R15-2D-401 in 2001. Both updates did not result in any substantive changes to the concepts introduced in the 1986 rule.

1994 ARIZONA APPELLATE COURT *TALLEY* DECISION

The 1994 *Talley* decision was a case of first impression for the Arizona Court of Appeals in applying combined filing principles, and the court quickly announced that it would not be bound by unitary decisions in other states. While the decision did not refer to the 1986 rule (perhaps because the tax year at issue predated the rule), it confirmed many of the rule's concepts and elaborated upon their rationale.

The *Talley* court ... stressed that the fundamental question in a unitary determination is whether the group filing is necessary to "clearly reflect the taxable income" earned by the entities.

Talley Industries Inc. (Talley) was the parent corporation of 25 wholly owned subsidiaries. The subsidiaries engaged in diverse businesses including manufacturing high technology products, manufacturing timepieces, importing men's and women's apparel, and buying and selling real estate. Talley asserted that its group of subsidiaries qualified as a unitary group that could file a combined Arizona return. Talley argued that it performed the following services or asserted the fol-

[9] Ariz. Admin. Code §§R15-2-1141(A)(8)(a) and -(b).

[10] Laws 1983, Ch. 287, §5.

[11] Currently renumbered as Ariz. Admin. Code §R15-2D-401.

[12] The rule provides that a transfer of over 20 percent of total goods manufactured or acquired is presumptive evidence of a substantial transfer.

[13] The rule suggests that the day-to-day operations of these entities use the same procedures and technologies that are developed, organized, purchased and/or prescribed by the central office of parent.

[14] Please see the appendix to this article for factors suggested by the rule that help support the existence of a unitary business.

lowing control over all of the subsidiaries: it prepared income tax returns, borrowed funds and acted as a banker, determined salary guidelines, designated accounting manuals and methodologies, set insurance requirements, and established employee benefit and pension plans. Between the subsidiaries there were shared trademarks, entity-wide training programs, and shared technical expertise.

Advocating the Intermediate Unitary Approach

In reaching its decision, the *Talley* court provided insight into the interpretation of Arizona's unitary rule. First, the court stressed that the fundamental question in a unitary determination is whether the group filing is necessary to "clearly reflect the taxable income" earned by the entities. Establishing such a broad and vague standard would appear to allow the court, and ultimately the department, to apply whatever elements were deemed reasonable in order to adjust a taxpayer's group into that which is determined to be "reflective" of Arizona taxable income. Such approach is supported by the court's statement that the application of a combined return falls under "*department* authority to require combined returns *when necessary* for accurately determining Arizona-source income." Accordingly, the standards used to evaluate a unitary determination are ultimately those established within the discretion of the department.

As a case of first impression, the court was tasked with developing Arizona's approach to interpreting the elements of a unitary business, and sought a more definitive test than other cases had enunciated. The court reviewed unitary concepts from several states to formulate Arizona's approach. The court viewed California's three-unities[15] test as being too broad and general to provide practical guidance in deciding unitary business controversies. Conversely, the court found that the narrow unitary tests of Louisiana and Mississippi were too restrictive.[16] The court instead focused on the "intermediate" approach advocated in Hellerstein's treatise as more closely reflecting the court's beliefs as to what a unitary relationship should require and providing a clearer guideline.[17] As cited by the court, the treatise states: "The recognition that an enterprise is not unitary unless, inter alia, there is a substantial interdependence of basic operations among the various affiliates or branches of the business provides a quantifiable, objective test of the unitary business."[18] Such an approach focused on whether there is a "substantial interdependence of basic operations among the various affiliates or branches of the business."

'Basic Operations' and Historical Development of the Unitary Doctrine

The *Talley* court found support for its "basic operations" test following an historical review of the unitary business doctrine. The doctrine was originally applied to:

- horizontally integrated businesses such as railroad and telegraph companies (with multiple entities operating in several states); and
- vertically integrated operations engaged in manufacturing, producing, and distributing a product.

Such vertically and horizontally integrated organizations are generally found to be unitary because of the inability to determine, under any practicable separate accounting method, the amount of income properly attributable to the various stages of the enterprise.

The court found that combined reporting addresses the inherent difficulty in establishing arm's-length prices for goods transferred within controlled subsidiaries of an organization. That same difficulty does not exist with activities such as centralized management or other internal services rendered by one affiliate to another. Such activities are considered to be *accessory* to the operations of the business because they are not contained in the final product or its delivery to the customer and can be *quantified* and charged to affiliates.

Application to Talley

Recognizing the critical difference between "basic" operations and "accessory" operations, the court applied its analysis to the facts in *Talley*. Despite the aforementioned factors, the court looked further as to whether any basic "operating ties" or "substantial interrelationships" existed among the subsidiaries. The court suggested that indicators of such a relationship would have included a transfer of material, goods, or technological data among the subsidiaries; a flow of product between the subsidiaries; or vertical or horizontal integration of business operations. The facts did not support the existence of any such relationship among the entities.

The court found that combined reporting addresses the inherent difficulty in establishing arm's-length prices for goods transferred within controlled subsidiaries of an organization.

While *Talley* provided centralized management and other internal services to its subsidiaries, such services were *capable of measurement*, in the court's view. Also, the services were not embodied in the product or its delivery and therefore were not so *pervasive as to negate the functional independence of its subsidiaries*. Accordingly, the court found that no unitary business existed between Talley and its affiliates.

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[15] A business is unitary if these circumstances are present: (1) unity of ownership; (2) unity of operation, as evidenced by central purchasing, advertising, accounting, and management divisions; and (3) unity of use of its centralized executive force and general system of operation.

[16] As an example of a narrow test for unitary business, the court cited *Texas Co. v. Cooper*, 107 S. 2d 676 (La. 1958), wherein an oil company that produced, refined, and sold oil products was found not to be unitary.

[17] Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, 2d.ed. (1993).

[18] *Talley*, 893 P.2d at 24, *citing* Hellerstein at P 8.11[5]m at 8-92.

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Woolworth

In *Woolworth*,[19] an unpublished 1997 decision, the Arizona Court of Appeals reinforced the substantial operational integration test established in *Talley*. F.W. Woolworth (FWW) argued that it was engaged in a unitary business with two of its wholly-owned subsidiaries: Kinney Shoe Corp. and Kinney Service Corp. (collectively, Kinney). FWW controlled many management decisions impacting the Kinney retail stores, held considerable bargaining power with mall landlords that helped Kinney lower its costs, and borrowed money for Kinney's benefit on better terms than Kinney would be able to procure on its own. FWW subsidiaries also provided Kinney with greater overseas purchasing efficiency.

The *Woolworth* court found that while the aforementioned activities were *essential* to Kinney's business, they did not constitute "basic operations."[20] According to the *Woolworth* court, *Talley* made clear that basic operations meant "*concrete business activities whose performance directly yields revenue to the enterprise.*"[21]

Because FWW's intercompany activities with Kinney were not "producing, refining, manufacturing, transporting, buying, selling" or similar services that were effectively *incorporated into Kinney's final product*, they did not rise to the level of being "basic operations" of Kinney to justify a unitary business. The services provided by FWW were quantifiable and could be charged through to Kinney without the same arm's-length pricing issues that exist with horizontally or vertically integrated organizations.

Woolworth is important not only in reiterating the *Talley* precepts, but also in applying them to affiliated entities in the same line of business (retail sales). Under Arizona's unitary test, being in the same line of business does not mean that the unitary criteria will be met automatically, which can catch taxpayers by surprise.

Phoenix Newspapers

In *Phoenix Newspapers Inc.*,[22] the Arizona Court of Appeals considered whether a partnership acted as a conduit to establish a unitary relationship between related entities.

Central Newspapers Inc. (CNI) was the parent company of Phoenix Newspapers Inc. (PNI), the publisher of an Arizona newspaper. CNI was also the parent of Central Newsprint Co. (Central Newsprint), which was the parent of Bradley Paper Co. (Bradley). Central Newsprint and Bradley held 10 percent and 3.5 percent interests, respectively, in Ponderay Newsprint Co. (Ponderay), which was a partnership formed to operate a newsprint mill in Washington. The majority interests were held by unrelated entities. Ponderay sold newsprint to PNI, as well as other newspaper publishers. Central Newsprint and Bradley were holding companies formed to ensure a supply of newsprint to PNI and had no other operations. In July 2000, PNI, Central Newsprint, and Bradley filed amended returns seeking refunds for tax years 1993 and 1994 on a combined basis.

After losing the argument that the group was unitary at the administrative appeals level and at the Arizona Tax Court, PNI, Central Newsprint, and Bradley filed an appeal with the court of appeals. Because the tax court had found no horizontal or vertical integration between the three entities, the issue before the court of appeals was whether the tax court had erred in its finding.

The taxpayers argued that, since Ponderay supplied 30 percent of the newsprint to PNI, Ponderay formed part of the vertically integrated newspaper business, and the three corporations, therefore, met the presumption of unity test caused by a transfer of 20 percent of the total goods annually acquired for processing found in Ariz. Admin. Code §R15-2D-401(G). Upholding the finding of the tax court on this issue, the court of appeals dismissed this argument because Ponderay was not an affiliated corporation, as required by the rule. The court also found no substantial interdependence between PNI, Central Newsprint, and Bradley beyond the minority interests in Ponderay held by the latter entities.

Because Central Newsprint and Bradley had no operations of their own, the taxpayers argued that the court of appeals should look through Ponderay and attribute its operations to the two partners. The court determined that even if a partnership's financial performance was imputed to its partners, the business activity of the partnership is not necessarily also imputed, since a partnership and its partners can be in different businesses. Likewise, the court rebuffed the taxpayers' argument that courts must look through holding companies to determine whether they are operationally integrated with another member of the group, particularly when there was no sharing of interdependent basic operations. Ultimately, the court held that the taxpayers failed to show that a combined return was necessary to accurately determine PNI's Arizona income.

R.R. Donnelley

In 2010, the Arizona Court of Appeals applied the principles of *Talley* and its progeny in *R.R. Donnelley*. The case involved the parent taxpayer, R.R. Donnelley & Sons Co. and three of its wholly owned subsidiaries: R.R. Donnelley Receivables Inc. (Receivables) that purchased accounts receivable and engaged in factoring; Heritage Preservation Corp. (Heritage) that held and managed trademarks transferred to it by Donnelley; and Caslon Inc. (Caslon) that supplied investment management services. Unlike the prior decisions discussed in this article, in *R.R. Donnelley* it was the department asserting that a unitary business existed between the taxpayer and its subsidiaries.

The court reviewed its determination in *Talley* and reiterated that a key factor in unitary determinations includes the distinction between "basic operations" and "accessory" functions. Accessory functions, for the most part, are not embodied in the product or its delivery to the customer. Such accessory functions can be charged to various affiliates and do not form the basis of a unitary business.

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[19] *F.W. Woolworth Co./Kinney Shoe Corp./Kinney Service Corp. v. Arizona*, No. 1 CA-TX 97-0007 (Ariz. App. Ct. Dec. 11, 1997), *cert. denied,* 1998 Ariz. LEXIS 693, No. CV-98-0095-PR (Ariz. Sept. 19, 1998).

[20] *Id.*

[21] *Id.* (emphasis added).

[22] *Phoenix Newspapers Inc. v. Arizona Dept. of Rev.*, Ariz. App. Ct., No 1 CA-TX 04-0014, 2005 Ariz. App. LEXIS 175 (Dec. 6, 2005).

Receivables Affiliate—Not Unitary

Receivables purchased Donnelley's accounts receivables and performed collections on those receivables. While the court recognized that a flow of intangibles could form the basis of a unitary relationship, the intangibles must contribute to the interdependence among entities. In this case, the services were provided at arm's length and were no different than factoring services that could have been provided by a third party. Accordingly, the services performed by Receivables were accessory to Donnelley's core business operations and did not form the basis of a unitary relationship.

Investment Affiliate—Not Unitary

Caslon's activities included buying and selling investment assets and borrowing and lending money at arm's length to Donnelley and its affiliates. Caslon and Donnelley did not share any employees, advertising, legal services, or centralized purchasing. The court found that the activities at issue were accessory services rather than basic operational activities. One reason for the court's conclusion was that the intangible assets were neither embodied in the product nor its delivery.

Trademark Affiliate—Unitary

Heritage was formed to hold and manage Donnelley's trademarks. Donnelley transferred its trademarks to Heritage, and Heritage licensed them back to Donnelley in exchange for royalties. The court focused on two aspects of its substantial operational integration test to find that a unitary business did exist in this instance. In its analysis, the court distinguished Heritage's services from ''accessory'' services.

First, the *Donnelley* court recognized that an ''accessory'' service, as defined in *Talley*, is not contained in the product or its delivery to the customer. Regarding the intangibles held by Heritage, they *were* embodied in the delivery of Donnelley's products to its customers. The trademarks appeared on shipping labels, invoices, signage, letterhead, and Donnelley's website and, therefore, were ''fully and completely'' operationally integrated with the delivery and distribution of Donnelley's products to its customers.

Secondly, the court noted that an ''accessory'' service is one that cannot be ''so pervasive as to negate functional independence.'' In this instance, functional interdependence was present because:

- Heritage received around 80 percent of its total revenue from Donnelley, and

- Heritage had only one employee for an entity that grossed up to $100 million of annual royalty revenue.

Additionally, the trademarks were incorporated into essential aspects of Donnelley's business. Because of this functional interdependence, the services could not be considered to be ''accessory'' and, therefore, supported a unitary relationship between Heritage and Donnelley.

CONCLUSION

Arizona's unitary business approach is unique among the states. For many states, a finding of centralized management, the same or similar line of business, or shared overhead functions goes a long way to supporting a unitary relationship among entities. That said, it may come as a surprise to taxpayers that a unitary determination in one state may not generate the same result in Arizona.

Arizona's statutory structure provides authority to the department to create the standards by which to measure a unitary relationship. Under department rules, as supported by case law, taxpayers must differentiate between relationships that support operational interdependence among entities and those that are merely accessory to business operations. As such, it is essential for taxpayers that anticipate filing an Arizona combined return to evaluate critically the nature of intercompany operational relationships that exist between affiliated entities. Only after establishing that the entities are integrated and interdependent in their business activities at the revenue producing level can a group of taxpayers support a unitary finding in Arizona. If these tests are not met, or if it is doubtful that they are, a taxpayer wishing to file a group return should carefully evaluate whether alternative filing options, such as a consolidated return, would be more appropriate for its affiliated group.

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Factors Enumerated in Arizona Admin. Code §15-2D-401.E That Indicate Operational Integration (Formerly Ariz. Admin. Code §15-2-1131E)

Factors that indicate operational integration include the following:

- the same or similar business conducted by components;
- vertical development of a product by components, *i.e.*, manufacturing, distribution, and sales;
- horizontal development of a product by components, i.e., sales, service, and repair financing;
- transfer of materials, goods, products, and technological data and processes between components;
- sharing of assets by components;
- sharing or exchanging of operational employees by components;
- centralized training of employees;
- centralized mass purchasing of inventory, materials, equipment, technology, etc.;
- centralized development and distribution of technology relating to the on-going day-to-day operations of the components;
- use of common trademark or logo at the basic operational level, centralized advertising with impact at the basic operational level;
- exclusive sales-purchase agreements between components;
- price differentials between components as compared to unrelated businesses;
- sales or leases between components; and
- other contributions between components at the basic operational level.