Importance of a Detailed Definition of Unitary Group

Several members expressed opinions about the importance of the definition of unitary group for the following reasons:

- states and companies have been involved in costly litigation regarding group composition;
- the same words may be interpreted differently state by state; and
- ambiguity has allowed auditors to base group composition on tax liability

The remainder of this document consists of four different unitary group definitions from Utah, California, Wisconsin, and the Multi State Tax Commission (MTC). It is interesting to note the vast differences within the definitions. Utah's definition is concise and provides little detail regarding the existence of the factors required to demonstrate unity. California's definition relies on case law and mentions that unity will be determined on a case by case basis. Wisconsin's provides more detail regarding the factors that demonstrate unity than Utah's, but far less than the MTC's. The MTC seems to provide the most guidance within their definition, which also includes a few general examples.

Utah – Utah Code §59-7

- "Unitary group" means a group of corporations that:
  - are related through common ownership; and
  - by a preponderance of the evidence as determined by a court of competent jurisdiction or the commission, are economically interdependent with one another as demonstrated by the following factors:
    (A) centralized management;
    (B) functional integration; and
    (C) economies of scale.
  - "Unitary group" includes a captive real estate investment trust
  - "Unitary group" does not include an S corporation
- Although not enacted, Utah has a proposed regulation (R865-6F08), which would further define a unitary business.

California FTB Notice 89-713

California courts have established two basic tests for determining the existence of a unitary business: the three unities test (Butler Brothers v. McColgan (1941) 17 Cal.2d 664) and the contribution or dependency test (Edison California Stores, Inc. v. McColgan (1947) 30 Cal.2d 472).

The United States Supreme Court has adopted its own test of what constitutes a unitary business, most notably, the Mobil test of "contributions to income result[ing] from functional integration, centralization of management, and economies of scale." Mobil Oil Corp. v. Vermont (1980) 445 U.S. 425 at 438.

The three unities and contribution or dependency tests continue to be valid standards for determining the existence of a unitary business, but the Mobil statement of what constitutes a unitary business is perceived by many to provide a better analytical framework and to be the most easily applied. Recent State Board of Equalization decisions cite all three standards but premise their analysis upon the Mobil standard. Therefore, the Mobil test, as applied in recent Board of Equalization opinions, will be the primary standard relied upon by the Franchise Tax Board in analyzing whether a unitary business exists.

The Franchise Tax Board will continue to administer the law with respect to what constitutes a unitary business on a case by-case basis. The appropriate weight to be given factual elements in various contexts, as well as their potential interactive significance, will be determined by the trends established by court decisions and opinions of the California State Board of Equalization. Adjustments will be made for new trends or principles evolving from future cases and/or opinions.

Wisconsin 71.255

"Unitary business" means a single economic enterprise that is made up either of separate parts of a single business entity, of multiple business entities that are related under section 267 or 1563 of the Internal Revenue Code, or of 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. Two or more business entities are presumed to be a unitary business if the businesses have unity of ownership, operation, and use as indicated by a centralized management or a centralized executive force; centralized purchasing, advertising, or accounting; intercorporate sales or leases; intercorporate services, including administrative, employee benefits, human resources, legal, financial, and cash management services; intercorporate debts; intercorporate use of proprietary materials; interlocking directorates; or interlocking corporate officers. In no event and under no circumstances shall the preceding sentence be construed as exclusive of any and all other factors indicative of a unitary business. For purposes of this section, the term "unitary business" shall be broadly construed, to the extent permitted by the U.S. Constitution. The members of a combined group shall be jointly and severally liable for costs, penalties, interests, and taxes associated with the combined report. Any business conducted by a pass-through entity that is owned directly or indirectly by a corporation shall be treated as conducted by the corporation, to the extent of the corporation's distributive share of the pass-through entity's income, regardless of the percentage of the corporation's ownership interest. A business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a pass-through entity if there is a synergy and exchange and flow of value between the 2 parts of the business and the 2 corporations are members of the same commonly controlled group.

Multi State Tax Commission
MTC Reg. IV.1.(b). Principles for Determining the Existence of a Unitary Business.

(1) Unitary Business Principle.

(A) The Concept of a Unitary Business. A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of 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. This flow of value to a business entity located in this state that comes from being part of a unitary business conducted both within and without this State is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion business income of the unitary business, even if that income arises in part from activities conducted outside the state. The business income of the unitary business is then apportioned to this state using an apportionment percentage provided by [insert your state statute].

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business or are dependent upon the activities of another business, those businesses are part of a unitary business.

(B) Constitutional Requirement for a Unitary Business. The sharing or exchange of value described in subsection (A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no operational relationship to the unitary business.

In this State, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

(C) Separate Trades or Businesses Conducted within a Single Entity. A single entity may have more than one unitary business. In such cases it is necessary to determine the business, or apportionable, income attributable to each separate unitary business as well as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

(D)Unitary Business Unaffected by Formal Business Organization. A unitary business may exist within a single business entity or among a commonly controlled group of business entities. The scope of what is included in a commonly controlled group of business entities is set forth in Section V below.

(2) Determination of a Unitary Business

(A) A unitary business is characterized by significant flows of value evidenced by factors such as those described in Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. [RESERVED: See regulation concerning passive holding companies for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations.] Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one or more of the factors mentioned above.

(B) Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale.
1. *Functional integration*: Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

a. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among business entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.

b. *Common Marketing*. The sharing of common marketing features among business entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the business entities' products, services, or intangibles are distributed or sold to a common customer, when the business entities use a common trade name or other common identification, or when the business entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)

c. *Transfer or Pooling of Technical Information or Intellectual Property*. Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, provide evidence of functional integration when the matter transferred is significant to the businesses' operations.

d. *Common Distribution System*. Use of a common distribution system by the business entities, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network provides evidence of functional integration.

e. *Common Purchasing*. Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.

f. *Common or Intercompany Financing*. Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. (See below for discussion of centralization of management.)

2. *Centralization of Management*. Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single business entity to another division within a business entity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized,

so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

a. *Facts Providing Evidence of Centralization of Management*. Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.

b. *Stewardship Distinguished*. Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.

3. *Economies of Scale*. Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.

a. *Centralized Purchasing*. Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.

b. *Centralized Administrative Functions*. The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. A business entity that secures savings in the performance of corporate administrative services due to its affiliation with other business entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

(3) Indicators of a Unitary Business.

(A) *Same Type of Business*. Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.

(B) *Steps in a Vertical Process*. Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.

(C) *Strong Centralized Management*. Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.