

Multistate Tax Commission—November 1996 Draft

DEFINITION OF A UNITARY BUSINESS

(Omitting Issue of Unity of Ownership or Control and Other Issues
for the Time Being)

1 I. APPLICATION OF REGULATION.

2 A. *Subject of Regulation.* This regulation provides
3 standards for determining the scope of a
4 unitary business. [Optional language for States employing
5 combined reporting: Because this State applies
6 combined reporting in one of its
7 constitutionally permitted
8 forms, determination of the scope of a unitary
9 business, part of which is conducted in this
10 State, is the first step for determining what
11 business entities are included in the combined
12 group.] The decisions of the United States
13 Supreme Court require all States *which require*
14 *apportionment of business income* to determine
15 the scope of a unitary business for purposes of
16 determining whether specific items of income or
17 loss are properly subject to apportionment by
18 the taxing State. See MTC Reg. IV.** (1996) for
19 a description of the steps necessary to
20 conclude whether items of income or loss are
21 apportionable or subject to specific
22 allocation.

23 B. *Definitions.* The following definitions apply to
24 this regulation:

25 1. "Business segment" means any grouping of
26 business activities, functions, or
27 transactions.

28 2. "Business entity" means each type of
29 organization which [this State's
30 income/franchise tax law] recognizes as an
31 reporting person, except such term does
32 not include an individual
33 [Insert other applicable exceptions: or
34 other exceptions].

35 3. "Enterprise" means a single entity or two
36 or more entities under common ownership or
37 control with respect to which [this
38 State's income/franchise tax] requires a

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39 determination of the unitary businesses
40 being conducted within this State.

41 4. "Combined report" means a series of
42 schedules which aggregate the business
25 43 income and apportionment factors of *two or*
44 *more business entities engaged in a*
45 *unitary business and apportion income to*
46 *respective states.*

47 II. EXISTENCE OF TRADE OR BUSINESS.

48 A. *Unitary Business Concept.* A unitary business is an
49 enterprise comprised of one or more business
50 segments that are sufficiently related to one
51 another for their business income to be aggregated
52 and apportioned by a common apportionment formula.
53 Where an enterprise consists of more than one
54 business segment, it is necessary to determine
55 whether the different business segments constitute
56 a single unitary business, or whether the
57 enterprise has more than one unitary business.

58 B. *Diverse Lines of Business.* Business segments
59 conducting seemingly unrelated and diverse
60 business operations may nevertheless constitute
61 parts of a unitary business depending upon the
62 extent of the interdependence, integration, and
63 interrelationship between the business segments.
64 The determination of whether business segments
65 conducting diverse lines of business constitute a
66 unitary business involves the application of the
67 same principles, described below, that are
68 applicable to determining the scope of any unitary
69 business. However, diversification of the
70 enterprise's portfolio and reducing the risks
71 inherent in being tied to one industry's business
72 cycle through the making of investments does not

73 by itself establish that the segments of an
74 enterprise constitute a unitary business.

75 [Optional language for States employing combined reporting: C.
76 *Commonly Owned or Controlled Business Entities.*
77 If an enterprise is comprised of two or more
78 commonly owned or controlled business entities or
79 segments engaged in a single unitary business, the
80 combined business income of the single unitary
81 business is then apportioned by a single formula

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82 which considers the instate and the out-of-state
83 factors that relate to that unitary business.]

84 [Optional language for States that do not employ combined reporting:
85 C. *Apportionment of Income of Separate Entity.*
86 Income subject to apportionment is determined
87 [insert or acknowledge possible exceptions: , subject to
88 special exceptions,] by reference to the income of
89 each unitary business of each separate business
90 entity. This apportionment is accomplished
91 without regard to whether other business entities
92 under common ownership or control are in the same
93 unitary business.]

94 D. *Separate Trades or Businesses Conducted within a*
95 *Single Entity.* An enterprise structured as a
96 single entity may have more than one unitary
97 business. In such cases it is necessary,
98 regardless of the application of combined
99 reporting, to determine the business, or
100 apportionable, income attributable to each
101 separate unitary business and the nonbusiness
102 income which is specifically allocated. The
103 business income of each unitary business is then
104 apportioned by a formula that takes into
105 consideration the instate and the out-of-state
106 factors that relate to the respective unitary
107 business whose income is being apportioned. See
108 IV.A.3., below, for a presumption that arises from
109 the structure of an enterprise as a single
110 business entity.

111 III. DETERMINATION OF A UNITARY BUSINESS

112 A. *General Considerations.* [Alternative language for combined
113 reporting States:If] [Alternative language for single entity States:
114 Subject to the limitations imposed by this State's
115 single entity reporting system, if] one business
116 segment of an enterprise is sufficiently related
117 to one or more of the enterprise's other business
118 segments to constitute a single unitary business,
119 then that portion of the business income of the
120 unitary business that is attributable to the
121 taxing State is determined by formula
122 apportionment based upon factors attributable to
123 that entire unitary business. Even if only one
124 business segment of an enterprise operates within
125 a single state, if that business segment is part

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126 of a unitary business conducted within and without
127 this State, the combined business income of all
128 business segments of that unitary business is
129 properly subject to apportionment by formula.

130 B. *Unitary Business Unaffected by Formal Business*
131 *Organization.* The formal business organization of
132 an enterprise does not affect the determination of
133 the scope of a unitary business. A unitary
134 business may exist within a single business entity
135 or among commonly owned or controlled business
136 entities.

137 C. *Description of Tests Used to Determine Scope of*
138 *Unitary Business.* A unitary business is present
139 among the enterprise's business segments when
140 there is some sharing or exchange of value (a
86-87 141 concept that is not limited to, but includes, a
142 "flow of goods"). ~~This sharing or exchange of~~
143 ~~value is not necessarily capable of precise~~
144 ~~identification or measurement.~~ A sharing or
145 exchange of value that will define the scope of a
146 unitary business is distinguished from the mere
147 flow of funds arising out of a passive investment
148 or a distinct business operation. ~~Evaluation of~~
90-97 149 ~~the objective characteristics of an investment's~~

150 ~~use and the investment's relation to the~~
151 ~~enterprise and the business being conducted by the~~
90-97 152 ~~enterprise within the taxing State will indicate~~
153 ~~whether there is a mere flow of funds arising out~~
154 ~~of a passive investment.~~ If the investment
155 furthers the business being conducted within the
156 taxing State beyond mere financial betterment in
157 general, the investment is not passive. A passive
158 activity is an investment activity not related to
159 the conduct of a unitary business.

160 Satisfaction of any of the following three
161 alternative tests establishes the presence of a
162 unitary business, subject to the additional
163 requirement of unity of control that is described
164 in Reg. ***.

165 1. *Contribution or Dependency Test.* The
166 operation of one business segment is
167 dependent upon, or contributes to, the
168 operation of another business segment; or

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- 169 2. *Three Unities Test.* Among the enterprise's
170 business segments there is a unity of
171 ownership, a unity of operation as evidenced
172 by central purchasing, advertising,
173 accounting and management divisions, and a
174 unity of use of the centralized executive
175 force and general system of operation; or
- 176 3. *Mobil Factors Test.* The enterprise's business
177 segments exhibit functional integration,
178 centralization of management, and economies
179 of scale. These alternative tests examine
180 whether the business segments operate as an
181 integrated whole or exhibit substantial
182 mutual interdependence. See Reg. *** for
183 special rules that govern the determination
184 of whether a pure or passive holding company
185 constitutes a part of a unitary business with
186 one or more affiliates conducting active
187 business operations.

188 D. *Analysis of the Three Alternative Tests of a*
189 *Unitary Business.* The following analytical
190 principles assist the application of the three
191 alternative tests described in III.C., above.

192 1. *Contribution/Dependency Disjunctive.* The
193 contribution or dependency test is phrased in
194 the disjunctive. If the activities of a
195 business segment either contributes to the
196 activities of another business segment or are
197 dependent upon the activities of another
198 business segment, a unitary business exists.

199 2. *Three Unities Overall Test.* Under the three
200 unities test, the distinction between unity
201 of use and unity of operation is not always
202 precise. Certain relationships between
203 business segments may satisfy either part of
204 the test. The determination of whether a
205 unitary business exists is made on the basis
206 of an overall evaluation and there is no
126,127 207 prescribed universally applicable level of
208 unity of operation or unity of use which must
209 be present in every case.

210 3. *Mobil Factors Test Overall Test.* Under the
211 *Mobil* factors test, the distinction between
212 the three analytical factors is not always

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130 213 precise. Certain relationships between
214 business segments ~~may satisfy~~ support a
215 finding for any one or more of the factors.
216 The determination of whether a unitary
217 business exists is made on the basis of an
132 218 overall evaluation and there is no ~~prescribed~~
219 *universally applicable* level of each of the
220 factors that must be present in each case.
221 Application of the *Mobil* factors to the facts
222 of each case will determine whether there is
223 sufficient sharing or exchange of value among
224 the business segments that the business
225 segments being examined constitute an
226 integrated whole, or exhibit substantial

137 227 mutual interdependence, of a single *unitary*
228 business.

229 4. *Classification of Particular Business*
230 *Operations.* Under the *Mobil* factors test, a
,140 231 particular business ~~operation~~ activity may be
232 suggestive of one or more of the factors. In
233 these circumstances, it is unimportant
234 whether the particular business ~~operation~~
235 activity is unambiguously classified as
236 either functional integration, or
237 centralization of management, or economies of
238 scale. The absence of a particular business
239 ~~operation~~ activity from the list set forth
240 under a specific analytical factor in the
241 subsequent part of this regulation does not
242 indicate that integration of the missing
243 business ~~operation~~ activity among the
244 business segments being analyzed is
245 insignificant or irrelevant to determining
246 the presence of the factor. The lists are
247 examples only, and not inclusive
248 descriptions, of the *Mobil* factors.

249 5. *Illustration of Mobil Factors Test.*
250 Functional integration, centralization of
251 management, and economies of scale are
252 illustrated as follows:

253 a. *Functional integration:* Functional
254 integration refers to transfers between
255 or pooling among business segments that
256 significantly affect the business

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257 operations of the segments. Functional
258 integration includes, but is not limited
259 to, transfers or pooling with respect to
260 the enterprise's products or services,
261 technical information, marketing
262 information, distribution systems,
263 purchasing, and intangibles such as
264 patents, trademarks, service marks,
265 copyrights, and trade secrets, know-how,

266 formulas, and processes. There is no
267 specific type of functional integration
268 that must be present. Facts suggesting
269 the presence of functional integration
270 should be analyzed in combination for
271 their cumulative effect and not in
272 isolation. The following is a list of
273 examples of business operations that can
274 support the finding of functional
275 integration. The order of the list does
276 not establish a hierarchy of importance.

277 i. Sales, exchanges, or transfers
278 (collectively "sales") of products,
279 services, and/or intangibles
163 280 between business segments *may*
281 indicate functional integration.
282 The significance of the
283 intercompany sales to the finding
284 of functional integration will be
285 affected by the character of what
286 is sold and/or the percentage of
287 total sales or purchases
288 represented by the intercompany
289 sales. For example, sales among
290 business segments constituting a
291 vertically integrated enterprise ~~is~~
292 *may be* indicative of functional
293 integration. Functional
294 integration is not negated by the
295 use of a readily determinable
296 market price to effect the
297 intercompany sales, because
298 the sales can represent an assured
299 market for the seller or an assured
300 source of supply for the purchaser.

301 ii. *Common Marketing.* The sharing of
302 common marketing features among

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303 business segments ~~is~~ may be an
304 indication of functional
305 integration when such marketing

306 results in significant mutual
307 advantage. Common marketing exists
308 when a substantial portion of the
309 business segments' products,
310 services, or intangibles are
311 distributed or sold to a common
312 customer, when the business
313 segments use a common trade name or
314 other common identification, or
315 when the business segments seek to
316 identify themselves to their
317 customers as a member of the same
318 enterprise. The use of a common
319 advertising agency or a commonly
320 owned or controlled in-house
321 advertising office does not by
322 itself establish common marketing
323 that is suggestive of functional
324 integration. (That activity,
325 however, is relevant to determining
326 the existence of economies of scale
327 and/or centralization of
328 management.)

329 iii. *Transfer or Pooling of Technical*
330 *Information or Intellectual*
331 *Property.* Transfers or pooling of
332 technical information or
333 intellectual property, such as
334 patents, copyrights, trademarks and
335 service marks, trade secrets,
336 processes or formulas, know-
163 337 how, research, or development, may
338 indicate functional integration
339 when the matter transferred is
340 significant to the business
341 segments' operations.

342 iv. *Common Distribution System.*
343 Use of a common distribution system
344 by the business segments, under
345 which inventory control and

346 accounting, storage, trafficking,

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347 and/or transportation are
348 controlled through a common network
349 indicates functional integration.

350 v. *Common Purchasing.* Common
351 purchasing of substantial
352 quantities of products, services,
353 or intangibles from the same source
354 by the business segments, where the
355 purchasing results in significant
356 cost savings or where the products,
357 services or intangibles are not
358 readily available from other
359 sources and are significant to each
360 segment's operations or sales,
361 indicates functional integration.

362 vi. *Common or Intercompany Financing.*
363 Significant common or intercompany
364 financing, including the guarantee
365 by, or the pledging of the credit
366 of, one or more business segments
367 for the benefit of another business
368 segment or segments indicates
369 functional integration, if the
370 financing activity serves an
371 operational purpose of both
372 borrower and lender. Lending which
373 serves an investment purpose of the
374 lender does not necessarily
375 indicate functional integration.
376 (See III.D.5.b., below, for
377 discussion of centralization of
378 management.)

379 vii. Other. [Reserved].

380 b. *Centralization of Management.*
381 Centralization of management exists when
382 directors, officers, and/or other
383 management employees jointly participate

384 in the management decisions which affect
385 the respective business segments.
386 Centralization of management can exist
387 whether the centralization is effected
388 from a parent entity to a subsidiary
389 entity, from a subsidiary entity to a
390 parent entity, from one subsidiary

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391 entity to another, from one division
392 within a single business entity to
393 another division within a business
394 entity, or from any combination of the
221-224 395 foregoing. ~~Centralization of management~~
396 ~~exists under the foregoing standard even~~
397 ~~when day-to-day management~~
398 ~~responsibility and accountability~~
399 ~~has been decentralized, so long as the~~
400 ~~management normally has an operational~~
401 ~~role with respect to the business~~
402 ~~segments. An operational role can be~~
403 effected through mandates, consensus
226 404 building, ~~implicit informal~~
405 understandings of the overall
406 operational strategy of the enterprise,
407 or any other mechanism that establishes
408 joint management.

409 i. *Facts Indicating Centralization of*
410 *Management.* Centralization of
411 management is indicated when
412 management of the operations of the
413 business segments is conducted to
414 integrate a significant aspect of
415 those operations. (The order of
416 the following discussion does not
417 establish a hierarchy of
418 importance.) Centralization of
419 management is indicated when
420 management operates to ensure that
421 the business segments are operated
422 for the benefit of the whole and
423 not just for their own individual
424 interests. Centralization of

425 management is indicated when
426 management transfers knowledge and
427 expertise to the other segments or
428 by the existence of common
429 standards of professionalism,
430 profitability, and/or ethical
431 practices that apply to the
432 business segments, or the transfer
433 or rotation of officers or other
434 management employees among the
435 business segments. Existence of
436 common officers and directors,
437 while relevant to a showing of

438 centralization of management, does
439 not alone indicate centralization
440 of management. Common officers are
441 more likely to indicate
442 centralization of management than
443 are common directors.

444 ii. *Stewardship Responsibilities*
445 *Distinguished.* Centralized efforts
446 to fulfill stewardship
447 responsibilities does not indicate
448 centralization of management.
449 Stewardship responsibilities are
450 those steps that any owner would
451 take to safeguard an investment.
452 Stewardship responsibility is
453 distinguished from those steps that
454 an owner may take to enhance value
455 by integrating one or more
456 significant operating aspects of
457 one business segment with the other
458 business segments of the owner.
459 For example, implementing reporting
460 requirements or requiring approval
461 of capital expenditures on a
462 segment-by-segment basis without
463 regard to the overall capital needs
464 of the business segments as a whole
465 generally discharges stewardship

466 responsibilities. On the other
467 hand, implementing internal
468 controls, like centralized
469 budgeting, that require approval of
470 significant capital expenditures,
471 thereby ensuring that the available
472 capital of the enterprise is used
473 to the best advantage of the col-
474 lective whole, when combined with
475 the existence of a centralized
476 cash management function for the
477 business segments, goes beyond
478 mere stewardship.

479 iii. *Same Business Line or Vertically*
480 *Integrated Enterprise.* Business
481 segments engaged in the same
482 general line of business or
483 fulfilling constituent steps in a

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484 vertically integrated enterprise
485 employ these circumstances to make
486 use of readily transferable
487 knowledge and expertise of the
488 operations of the other segments
489 and/or to develop coordination
490 between the business segments for
491 the mutual benefit of the segments
492 and thereby indicate centralization
493 of management.

494 iv. *Business Segments within a Single*
495 *Business Entity.* Business segments
496 operated within the organizational
497 structure of a single business
498 entity indicate centralization of
499 management when management by
500 virtue of its necessarily
501 centralized role as management to
502 the business entity as a whole
503 will likely integrate the
504 operations of the business segments
505 to further the objectives of the

506 single business entity. See
507 IV.A.3., below, for an
508 administrative presumption that
509 applies to business segments within
510 a single entity.

511 c. *Economies of Scale.* Activity among
512 and between business segments
513 resulting in a significant decrease
514 in the average per unit cost of
515 operational or administrative
516 functions due to the increase in
517 operational size indicates
518 economies of scale. Economies of
519 scale may exist from the inherent
520 cost savings that arise from the
521 presence of functional integration
522 or centralization of management.
523 The following are examples of
524 business operations that can
525 support the finding of
526 economies of scale. The order of
527 the list does not establish a
528 hierarchy of importance.

529 (I) *Centralized Purchasing.*
530 Centralized purchasing
531 designed to achieve
532 savings due to the volume of
533 purchases, the timing of
534 purchases, or the
535 interchangeability of
536 purchased items among the
537 purchasing business segments
538 indicates economies of scale.

539 (ii) *Centralized Administrative*
540 *Functions.* The performance of
541 traditional corporate
542 administrative functions, such
543 as legal services,
294,295 544 ~~accounting, tax~~

545 ~~administration,~~ pension and
546 other employee benefit *and*
294,295 547 ~~administration, and financial~~
548 ~~reporting,~~ in common among the
549 business segments may result
550 in economies of scale. A
551 business segment that secures
552 savings in the performance of
553 corporate administrative
554 services due to its
555 affiliation with other
556 business segments that it
557 would not otherwise reasonably
558 be able to secure on its own
559 because of its size, financial
560 resources, or available
561 market, indicates economies of
562 scale.

563 IV. EVIDENCE AND PRESUMPTIONS

564 A. *Presumptions Identified.* The presumptions
565 described below will be utilized to assist in
566 determining the scope of a unitary business. The
567 taxpayer may rebut by clear and cogent evidence
568 that application of the presumption will result in
569 the State taxing extraterritorial values or
570 attributing to the State income that is all out of
571 appropriate proportions to the business transacted
572 in the State. This proof overcomes the result
573 achieved by the application of any presumption

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574 described below.

575 1. *Same Type of Business.* Business segments
576 that are in the same general line of business
577 are generally engaged in a single unitary
578 business, as, for example, a ~~multistate~~
312 579 ~~grocery operation chain of multistate grocery~~
580 ~~stores.~~

581 2. *Steps in a Vertical Process.* Business
582 segments that are engaged in different steps

583 in a vertically structured enterprise are
584 almost always engaged in a single unitary
585 business. For example, an enterprise engaged
586 in the exploration, development, extraction,
587 and processing of a natural resource and the
588 subsequent sale of a product ~~based upon~~
317 589 *produced from* the extracted natural resource,
318 590 *is presumed* engaged in a single unitary
591 business, regardless of the fact that the
592 various steps in the process are operated
593 substantially independently of each other
594 with only general supervision from the
595 enterprise's executive offices.

322-325 596 ~~3. *Business Segments within a Single Business*~~
597 ~~*Entity.* A single business entity is~~
598 ~~generally engaged in a single unitary~~
599 ~~business with respect to the business~~
600 ~~segments operated within the organizational~~
601 ~~structure of the single business entity. See~~
602 ~~III.D.5.b.iv., above.~~

603 ~~4.~~ 3. *Strong Centralized Management.* Business
604 segments which might otherwise be considered
605 as engaged in more than one unitary business
606 are properly considered as engaged in one
607 unitary business when, for example,
608 there is a strong central management, coupled
609 with the existence of centralized departments
610 for such functions as financing, advertising,
611 research, or purchasing. For example, some
612 enterprises conducting diverse lines of
613 business may properly be considered as
614 engaged in only one unitary business when the
615 central executive officers are normally
616 involved in the operations of the various
617 business segments and there are centralized

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- 618 offices which perform for the business
619 segments the normal matters which a truly
620 independent business would perform for
621 itself, such as ~~accounting, personnel,~~
336,337 622 ~~insurance,~~ legal, purchasing, or advertising,

337 623 ~~or financing.~~ The absence of these described
624 conditions does not, however, preclude the
625 finding of a unitary business based upon
626 other indicative conditions.

627 B. *Reporting Positions as Evidence.* Inconsistent
628 reporting positions of a business entity may
629 indicate that the business segment's
630 reporting positions regarding the existence
631 or nonexistence of a unitary business are in
632 error.

633 1. *Inconsistent Reporting Positions in*
634 *Taxing State.* [The state tax
635 administrator] may rely on the evidence
636 of inconsistent reporting positions in
343-356 637 this State *under substantially the same*
638 *facts* from one reporting period to the
639 next to treat business segments as
640 engaged in

641 a. A unitary business, when the
642 business segments' return or
643 returns previously filed with this
644 State have treated the business
645 segments as a unitary business and
646 the business segments' change in
647 their reporting position will
648 result in a substantial tax benefit
649 not otherwise available, or

650 b. Separate businesses, when the
651 business segments' return or
652 returns previously filed with this
653 State have treated the business
654 segments as separate businesses,
655 and the business segments' change
656 in their reporting position will
657 result in a substantial tax benefit
658 not otherwise available.

659 2. *Inconsistent Treatment between States*

660 *with Substantially Similar Unitary*
661 *Standards for the Same Tax Period.* [The
662 state tax administrator] may rely on the
663 evidence of inconsistent reporting
664 positions with respect to the same
665 reporting period in this State and other
666 States with substantially similar
667 unitary business standards to treat
668 business segments as engaged in

669 a. a unitary business, when the
670 business segments' reporting
671 position filed with this State have
672 treated the business segments as
673 not in a unitary business, and the
674 business segment's reporting
675 position, for the same taxable
676 period, in another State or States
677 treated the business segments as
678 unitary, or

679 b. separate and distinct businesses,
680 when the business segments'
681 reporting position filed with this
682 State have treated the business
683 segments as unitary, and the
684 business segments reporting
685 position, for the same taxable
686 period, in another State or States
687 treated the business segments as
688 separate and distinct businesses.