MINNESOTA Department of Revenue

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September 5, 1997

Mr. Brian W. Toman
California Franchise Tax Board - Legal Division
P. O. Box 1720
Rancho Cordova, CA 95741-1720

SEP 1 · 1997

Subject: Definition of a Unitary Business

Dear Mr. Toman:

During the July 17, 1997, teleconference it was suggested that members of Task Force C submit comments on a draft of the regulation on the definition of a unitary business that was submitted on July 7, 1997 by a member of Task Force C. Since I was not able to participate in the July 17, 1997 teleconference, I am submitting comments on this draft. I am also submitting some comments on the discussion in Whitefish, Montana on July 6, 1997. Hopefully these comments will be of some help during Task Force C's next teleconference.

Comments on July 7, 1997, Draft of the Regulation Defining a Unitary Business

I disagree with the manner in which the July 7, 1997, draft altered the regulation to make the Mobil three factors test (functional integration, centralized management, and economies of scale) as the "basic test." The July 7, 1997, draft does a disservice to the reader by noting that the decisions upholding the "three unities test," and the "contribution or dependency test," have precedential value[1] and then it fails to explain how these tests are to be applied.

The three unities test, and the contribution and dependency test, are valid tests that should be included in any regulation defining a unitary business. As you are aware, the three unities test is a long-established test for determining the existence of a unitary business,[2] and is used by many states (including California)[3] to determine whether corporations are engaged in a single unitary business. A number of states (including California) also use the contribution or dependency test for determining the existence of a unitary business.[4] These tests have not been replaced by the more recent decisions upholding a unitary finding when there is centralized management, functional integration, or economies of scale,[5] or when there is a "flow of value" between members of a unitary group.[6] As a result, any regulation defining a unitary business

[1] Definition of a Unitary Business, July 7, 1997 Draft, § III.D, p. 4.

[2] Edison California Stores v. McColgan, 183 P. 2d 16 (1947)

[3] *See* The Appeal of Beck/Arnley Corp. of California, SBE, 81-SBE-115, (09/29/82), The Appeal of Data General Corp, SBE 82-SBE-145 (07/26/82), The Appeal of Hollywood Film Enterprises, Inc., SBE, 82-SBE-052 (03/31/82), The Appeal of Power-Line Sales, Inc., SBE, 90-SBE-016 (12/31/90), The Appeal of Daniel Industries, Inc., SBE, 80-SBE-069, 06/30/80

[4] A.M. Castle & Co. v. California Franchise Tax Board, 36 Cal. App. 4th 1794 (July 25, 1995). (To the extent there is a conflict in the case law on this issue, we choose to follow the cases which suggest the two tests are alternative methods for determining unity.)

[5] Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 100 S.Ct. 1223, 1232 (1980)

[6] Container Corp. of America v. Franchise Tax Board, 103 S.Ct. 2933, 2947 (1983)

would be incomplete if it failed to address the three unities test or the contribution or dependency test.

By excluding the three unities test and the contribution and dependency test from the regulation, the Multistate Tax Commission could be sending a message that the three factors test of centralized management, functional integration, or economies of scale carries more weight than these other tests. I do not believe that this would be a correct assumption under California law, and it certainly would not be the case under Minnesota's unitary statute.[7]

I believe that the three unities test, the contribution or dependency test, and the test referenced in Mobil, are each distinct tests that may be applied to a set of facts to determine the existence of a unitary business. Nothing in Mobil or Container would suggest anything to the contrary.

There are situations in which group of corporations should be taxed as a unitary business even though the facts do not readily meet the standard of the Mobil factors test. For example, consider an out-of-state subsidiary that is not functionally integrated with its instate parent, and does not have common management with the parent. If the out-of-state subsidiary is dependent upon the in-state parent for daily, weekly, or monthly infusions of cash through loans (especially when the subsidiary does not have the ability to borrow from traditional third party financial sources), it can be argued that the subsidiary is dependent upon the financial resources of the parent, and therefore should be taxed as a single unitary business.

As a practical matter, the three unities test is easier to administer than the "Mobil three factors test." While centralized management and functional integration are fairly straight forward, it is difficult for auditors to establish the existence of economies of scale. For example, an auditor may "know" that economies of scale exist as a result of a centralized purchasing program. However, actually proving that a lower price was achieved through centralized purchasing may be difficult to prove through traditional unitary determination procedures. Actually establishing the existence of an economy of scale may require some economic analysis (such as determining the market price for the commodity purchased) in order to establish the existence of an economy of scale.

On the other hand, proving the existence of a unitary business through the three unities test is easier to establish. The auditor can examine the way in which the corporations have operated, and if there is sufficient unity of operation and unity of use (management), a conclusion can be drawn that there is an economies of scale arising from the operation of the business without having to actually prove such economy of scale. In short, there has always been, in my mind, and implicit assumption that a flow of value and economies of scale are achieved when the three unities test is met. As a result, the three unities test is a very pragmatic test in determining a unitary business.

I think it would be very difficult for a state, like Minnesota, to adopt a regulation on the definition of a unitary business that only references "Mobil three factors test" when such a state has adopted the contribution/dependency test and the three unities test by statute. It was my

[7] Minnesota Statute § 290.17, Subdivision 4.

intention to consider promulgating the Multistate Tax Commission's resulting regulation on the definition of a unitary business, as an update to the Minnesota regulations regarding the definition of a unitary business.[8] However, I do not believe that Minnesota could adopt such a regulation if it did not fully explain the tests currently utilized by Minnesota law.

Comments on Discussion at Whitefish, MT. Meeting.

At the meeting in Whitefish, several members of the PPWG, dealing with the definition of a unitary business, suggested that functional integration should only be considered as a unitary attribute when such integration involves line, rather than staff functions. A suggestion was made to incorporate this concept into the draft regulation. I disagree with the suggestion that functional integration that results in a flow of value, or economies of scale, only occurs in line functions. Integration of staff functions can and do produce a flow of value of the type contemplated by the United States Supreme Court in Container. For example, centralized purchasing, which one might categorize as a staff function, has clearly been used as a factor in determining the existence of a unitary business.[9] As a result, functional integration occurring through staff functions should be part of any regulation defining a unitary business.

I will be looking forward to discussing these issues with you, and the remainder of the members of Task Force C, on September 25, 1997.

Please call me at (612) 282-5747 if you have any questions regarding these matters.

Very Truly Yours,

William J. Lunka

William J. Lunka,
Corporate Technical Manager

cc: Mr. Michael Mazerov, Director of Communications, Multistate Tax Commission
Mr. Paull Mines, General Counsel, Multistate Tax Commission
Mr. Alan Friedman, Special Counsel, Multistate Tax Commission
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[8] Minnesota Regulation § 8019.0100.

[9] Container at 2947. (Assistance the subsidiary with the purchase of new and used equipment.)