

MEMORANDUM

RECEIVED
OCT 23 1997

MTV/DC

TO: Brian W. Toman
FROM: John S. Warren *JSW*
DATE: October 20, 1997
RE: Task Force C, Working Group on Definition/Tests of Unitary Business

I thought it might be helpful for your discussion in Washington on October 28, to have a draft which shows the deletions and additions in my July 7 draft plus those set out in your October 17 memorandum to the Task Force. Such draft is enclosed.

I offer the following comments on this draft:

1. With regard to "IV. Evidence and Presumptions", my memo of July 7 offered three alternative approaches. The enclosed draft incorporates only what I called the first alternative and adds your changes. (Note: The use of presumptions is a subject assigned to Task Force B, so I assume our proposals will need to be melded with theirs.)

2. The last insert in this draft was proposed in your memo of July 30 but was overlooked in my letter of September 11 and your memo of October 17. I think it is acceptable.

3. I apologize for not putting line numbers in this draft. It is beyond our word processing capabilities.

cc: Michael Mazerov ✓

Multistate Tax Commission

DEFINITION OF A UNITARY BUSINESS

(Toman-Warren October 1997 Draft)

I. APPLICATION OF REGULATION.

A. *Subject of Regulation.* This regulation provides standards for determining the scope of a unitary business. ^{[Optional Language for States employing combined reporting:} Because this State applies combined reporting in one of its constitutionally permitted forms, determination of the scope of a unitary business, part of which is conducted in this State, is the first step for determining what business entities are included in the combined group.] The decisions of the United States **which utilize formulary apportionment** Supreme Court require all States to determine the scope of a unitary business for purposes of determining whether specific items of income or loss are properly subject to apportionment by the taxing State. See MTC Reg. IV.** (1996) for a description of the steps necessary to conclude whether items of income or loss are apportionable or subject to specific allocation.

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

1. "Business segment" means any grouping of business activities, functions, or transactions.
2. "Business entity" means each type of organization which [this State's income/franchise tax law] recognizes as an reporting person, except such term does not include an individual [^{Insert other applicable exceptions:} or other exceptions].
3. "Enterprise" means a single entity or two or more entities under common ownership or control with respect to which [this State's income/franchise tax] requires a determination of the unitary businesses being conducted within this State.
4. "Combined report" means a series of schedules which aggregate the business income and apportionment factors of **two or more entities engaged in** a unitary business **and apportion income to the State.**

II. EXISTENCE OF TRADE OR BUSINESS.

A. *Unitary Business Concept.* A unitary business is an enterprise comprised of one or more business segments that are sufficiently

related to one another for their business income to be aggregated and apportioned by a common apportionment formula. Where an enterprise consists of more than one business segment, it is necessary to determine whether the different business segments constitute a single unitary business, or whether the enterprise has more than one unitary business.

- B. *Diverse Lines of Business.* Business segments conducting seemingly unrelated and diverse business operations may nevertheless constitute parts of a unitary business depending upon the extent of the interdependence, integration, and interrelationship between the business segments. The determination of whether business segments conducting diverse lines of business constitute a unitary business involves the application of the same principles, described below, that are applicable to determining the scope of any unitary business. However, diversification of the enterprise's portfolio and reducing the risks inherent in being tied to one industry's business cycle through the making of investments *in another line of business* does not by itself establish that the segments of an enterprise constitute a unitary business.

[Optional language for States employing combined reporting:

C. *Commonly Owned or Controlled Business Entities.* If an enterprise is comprised of two or more commonly owned or controlled business entities or segments engaged in a single unitary business, the combined business income of the single unitary business is then apportioned by a single formula which considers the in-state and the out-of-state factors that relate to that unitary business.]

[[Optional language for States that do not employ combined reporting:

C. *Apportionment of Income of Separate Entity.* Income subject to apportionment is determined [insert or acknowledge possible exceptions: , subject to special exceptions,] by reference to the income of each unitary business of each separate business entity. This apportionment is accomplished without regard to whether other business entities under common ownership or control are in the same unitary business.]

- D. *Separate Trades or Business Conducted within a Single Entity.* An enterprise structured as a single entity may have more than one unitary business. In such cases it is necessary, regardless of the application of combined reporting, to determine the business, or apportionable, income attributable to each separate unitary business and the 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. See ~~IV.A.3., below, for a presumption that arises from the structure of an enterprise as a single business entity.~~

III. DETERMINATION OF A UNITARY BUSINESS

- A. *General Considerations.* [~~Alternative language for single entity States:~~ ~~Subject to the limitations imposed by this State's single entity reporting system, if~~] [Alternative language for combined reporting States: ~~if~~] [Alternative language for single entity States: ~~Subject to the limitations imposed by this State's single entity reporting system, if~~] one business segment of an enterprise is sufficiently related to one or more of the enterprise's other business segments to constitute a single unitary business, then that portion of the business income of the unitary business that is attributable to the taxing State is determined by formula apportionment based upon factors attributable to that entire unitary business. Even if only one business segment of an enterprise operates within a single state, if that business segment is part of a unitary business conducted within and without this State, the combined business income of all business segments of that unitary business is properly subject to apportionment by formula.
- B. *Unitary Business Unaffected By Formal Business Organization.* The formal business organization of an enterprise does not affect the determination of the scope of a unitary business. A unitary business may exist within a single business entity or among commonly owned or controlled business entities.
- C. *Description of Test Approach Used to Determine Scope of Unitary Business.* A unitary business is present among the enterprise's business segments when there is some sharing or exchange of value (a concept that is not limited to, but includes, a "flow of goods"). This ~~sharing of exchange of value is not necessarily capable of precise identification or measurement.~~ A sharing or exchange of value that will define the scope of a unitary business is distinguished from the mere flow of funds arising out of a passive investment or a distinct business operation. ~~Evaluation of the objective characteristics of an investment's use and the investment's relation to the enterprises and the business being conducted by the enterprise within the taxing State will indicate whether there is a mere flow of funds arising out of a passive investment.~~ If the investment *an asset* furthers the business being

conducted within the taxing State beyond mere financial betterment in general, the investment *in the asset* is not passive. A passive activity is an investment activity not related to the conduct of a unitary business.

D. **Tests of a Unitary Business.** *State court decisions over the years have sometimes recited a "three unities" test of a unitary business, whereby among the enterprise's business segments there is a unity of ownership, a unity of operation as evidenced by central purchasing, advertising, accounting and management divisions, and a unity of use of the centralized executive force and general system of operation. Other court decisions have recited a "contribution or dependency" test whereby the operation of one business segment is dependent upon, or contributes to, the operation of another business segment. More recent decisions of the United States Supreme Court on the subject have stated that a unitary business exists where the enterprise's business segments exhibit functional integration, centralization of management, and economies of scale. While decisions reciting the three unities test and decisions reciting the contribution or dependency test continue to have precedential value, this regulation will concentrate on the elements of functional integration, centralized management, and economies of scale as more helpful guides to the existence of a unitary business.*

E. **Basic Test of a Unitary Business.** ~~Satisfaction of any of the following three alternative tests establishes the presence of a unitary business, subject **Subject** to the additional requirement of unity of control that is described in Reg. ***,~~ **the basic test of a unitary business is whether the**

- ~~1. **Contribution or Dependency Test.** The operation of one business segment is dependent upon, or contributes to, the operation of another business segment; or~~
- ~~2. **Three Unities Test.** Among the enterprise's business segments there is a unity of ownership, a unity of operation as evidenced by central purchasing, advertising, accounting and management divisions, and a unity of use of the centralized executive force and general system of operation; or~~

- ~~3. **Mobil Factors Test.** The enterprise's business segments exhibit functional integration, ~~centralized~~ **centralization** of management, and economies of scale.~~

~~These alternative tests examine whether the business segments operate as an integrated whole or exhibit substantial mutual interdependence. See Reg. *** 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.~~

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

- ~~1. **Contribution/Dependency Disjunctive.** The contribution or dependency test is phrased in the disjunctive. If the activities of a business segment either contribute to the activities of another business segment or are dependent upon the activities of another business segment, a unitary business exists.~~

- ~~2. **Three Unities Overall Test.** Under the three unities test, the distinction between unity of use and unity of operation is not always precise. Certain relationships between business segments may satisfy either part of the test. The determination of whether a unitary business exists is made on the basis of an overall evaluation and there is no prescribed level of unity of operation or unity of use which must be present in every case.~~

- ~~1. **Mobil Factors Test Overall Elements of the Basic Test.** Under the **Mobil factors basic** test, the distinction between the three analytical factors **elements** is not always precise. Certain relationships between business segments may **satisfy support a finding for** any one or more of the factors **elements**. The determination of whether a unitary business exists is made on the basis of an overall evaluation and there is no **prescribed universally applicable** level of each of the factors **elements** that must be present in each case. Application of the **Mobil factors this analysis** to the facts of each case will determine whether there is sufficient sharing or exchange of value among the business segments that the business segments being examined~~

constitute an integrated whole, or exhibit substantial mutual interdependence, of a single *unitary* business.

2. *Classification of Particular Business Operations.* ~~Under the Mobil factors test,~~ A particular business operation *activity* may be suggestive of one or more of the ~~factors~~ *elements*. In these circumstances, it is unimportant whether the particular business operation is unambiguously classified as either functional integration, or centralization of management, or economies of scale. The absence of a particular business operation *activity* from the list set forth under a specific analytical ~~factor~~ *element* in the subsequent part of this regulation does not indicate that integration of the missing business operation *activity* among the business segments being analyzed is insignificant or irrelevant to determining the presence of the ~~factor~~ *element*. The lists are examples only, and not inclusive descriptions, of the ~~Mobil factors~~ *basic elements*.
3. *Illustration of Mobil Factors Basic Test.* Functional integration, centralization of management, and economies of scale are illustrated as follows:
 - a. *Functional integration:* Functional integration refers to transfers between or pooling among business segments that significantly affect the business operations of the segments. Functional integration includes, but is not limited to, transfers or pooling with respect to the enterprise's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, and trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. Facts suggesting the presence of functional integration should be analyzed in combination for their cumulative effect and not in isolation. 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.

- i. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business segments **may** indicate 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 segments constituting a vertically integrated enterprise is **may be** indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because the sales can represent an assured market for the seller or an assured source of supply for the purchaser.
- ii. *Common Marketing.* The sharing of common marketing features among business segments is **may be** an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the business segments' products, services, or intangibles are distributed or sold to a common customer, when the business segments use a common trade name or other common identification, or when the business segments 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. (That activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)
- iii. *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, *may* indicate functional integration when the matter transferred is significant to the business segments' operations.

- iv. *Common Distribution System.* Use of a common distribution system by the business segments, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network indicates functional integration.
 - v. *Common Purchasing.* Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business segments, 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 segment's operations or sales, indicates functional integration.
 - vi. *Common or Intercompany Financing.* Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business segments for the benefit of another business segment or segments indicates 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 indicate functional integration. (See III.D-5.E.3.b., below, for discussion of centralization of management.)
 - vii. *Other.* [Reserved].
- b. *Centralization of Management.* Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions which affect the respective business segments. Centralization of management can exist whether the centralization is effected from a partner 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 exists under the foregoing standard even when day-to-day management responsibility and accountability has been decentralized, so long as the management normally has an operational role with respect to the business segments. An operational role can be effected through mandates, consensus building, ~~implicit~~ **informal** understandings of the overall operational strategy of the enterprise, or any other mechanism that establishes joint management.

- i. ***Facts Indicating Centralization of Management.***
Centralization of management is indicated when management of the operations of the business segments is conducted to integrate a significant aspect of those operations. (The order of the following discussion does not establish a hierarchy of importance.) Centralization of management is indicated when management operates to ensure that the business segments are operated for the benefit of the whole and not just for their own individual interests. Centralization of management is indicated when management transfers knowledge and expertise to the other segments or by the existence of common standards of professionalism, profitability, and/or ethical practices that apply to the business segments, or the transfer or rotation of officers or other management employees among the business segments. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone indicate centralization of management. Common officers are more likely to indicate centralization of management than are common directors.
- ii. ***Stewardship Responsibilities Distinguished.***
Centralized efforts to fulfill stewardship responsibilities does not indicate centralization of management. Stewardship responsibilities are those

steps that any owner would take to safeguard an investment. Stewardship responsibility is distinguished from those steps that an owner may take to enhance value by integrating one or more significant operating aspects of one business segment with the other business segments of the owner. For example, implementing reporting requirements or requiring approval of capital expenditures on a segment-by-segment basis without regard to the overall capital needs of the business segments as a whole generally discharges stewardship responsibilities. On the other hand, implementing internal controls, like centralized budgeting, that require approval of significant capital expenditures, thereby ensuring that the available capital of the enterprise is used to the best advantage of the collective whole, when combined with the existence of a centralized cash management function for the business segments, goes beyond mere stewardship.

- iii. *Same Business Line or Vertically Integrated Enterprise.* Business segments engaged in the same general line of business or fulfilling constituent steps in a vertically integrated enterprise employ these circumstances to make use of readily transferable knowledge and expertise of the operations of the other segments and/or to develop coordination between the business segments for the mutual benefit of the segments and thereby indicate centralization of management.
- iv. ~~*Business Segments within a Single Business Entity.*~~ ~~Business segments operated within the organizational structure of a single business entity indicates centralization of management when management by virtue of its necessarily centralized role as management to the business entity as a whole will likely integrate the operations of the business segments to further the objectives of the single business entity. See IV.A.3., below, for an~~

~~administrative presumption that applies to business segments within a single entity.~~

- c. *Economies of Scale.* Activity among and between business segments resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size indicates economies of scale. 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.
- (i) *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 purchasing business segments indicates economies of scale.
 - (ii) *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, accounting, tax administration, **and** pension and other employee benefit administration, ~~and financial reporting~~, in common among the business segments may result in economies of scale. A business segment that secures savings in the performance of corporate administrative services due to its affiliation with other business segments that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, indicates economies of scale.

IV. EVIDENCE AND PRESUMPTIONS

- A. *Presumptions Identified.* The presumptions described below will be utilized to assist in determining the scope of a unitary business. ~~The taxpayer~~ **A presumption may rebut be rebutted** by clear and cogent evidence that application of the presumption will result in ~~the State~~

~~taxing extraterritorial values or~~ attributing to the State income that is all out of *all* appropriate proportions to the business transacted in the State. This proof overcomes the result achieved by the application of any presumption described below.

1. *Same Type of Business.* Business segments that are in the same general line of business are **generally presumed to be** engaged in a single unitary business, as, for example, a **chain of** multistate grocery ~~operation~~ **stores**.

2. *Steps in a Vertical Process.* Business segments that are engaged in different steps in a vertically structured enterprise are ~~almost always~~ **presumed to be** engaged in a single unitary business. For example, an enterprise engaged in the exploration, development, extraction, and processing of a natural resource, and the subsequent sale of a product ~~based upon~~ **produced from** the extracted natural resources is **presumed to be** 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 enterprise's executive offices.

- ~~3. *Business Segments within a Single Business Entity.* A single business entity is generally engaged in a single unitary business with respect to the business segments operated within the organization structure of the single business entity. See III.D.5.b.iv., above.~~

3. *Strong Centralized Management.* Business segments which might otherwise be considered as engaged in more than one unitary business are ~~properly considered as~~ **presumed to be** engaged in one unitary business when, ~~for example,~~ there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. For example, some enterprises conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are normally involved in the operations of the various business segments and there are centralized offices which perform for the business segments the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal,

purchasing, advertising, or financing. ~~The absence of these described conditions does not, however, preclude the finding of a unitary business based upon other indicative conditions.~~

- B. *Reporting Positions As Evidence.* Inconsistent reporting positions of a business entity may indicate that the business segment's reporting positions regarding the existence or nonexistence of a unitary business are in error.
1. *Inconsistent Reporting Positions in Taxing State.* [The state tax administrator] may rely on the evidence of inconsistent reporting positions in this State ***under substantially the same facts*** from one reporting period to the next to treat business segments as engaged in
 - a. ***A*** unitary business, when the business segments' return or returns previously filed with this State have treated the business segments as a unitary business and the business segments' change in their reporting position will result in a substantial tax benefit not otherwise available, or
 - b. ~~separate~~ ***Separate*** businesses, when the business segments' return or returns previously filed with this State have treated the business segments as separate businesses, and the business segments' change in their reporting position will result in a substantial tax benefit not otherwise available.
 2. *Inconsistent Treatment between States with Substantially Similar Unitary Standards for the Same Tax Period.* [The state tax administrator] may rely on the evidence of inconsistent reporting positions with respect to the same reporting period in this State and other States with substantially similar unitary business standards to treat business segments as engaged in
 - a. a unitary business, when the business segments' reporting position filed with this state have treated the business segments as not in a unitary business, and the business segments' reporting position, for the same taxable period, in another State or States treated the business segments as unitary, or

- b. separate and distinct businesses, when the business segments' reporting position filed with this State have treated the business segments as unitary, and the business segments reporting position, for the same taxable period, in another State or States treated the business segments as separate and distinct businesses.

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