

COMMENTS ON DRAFT REGULATION DEFINING A UNITARY BUSINESS

By

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I first want to commend the authors for a remarkably good job overall. I find nothing in the draft that is totally mistaken, just a few things which I think could be improved.

General Criticism of the Three Unities and Contribution or Dependency Tests

I suggest that the time has come to jettison both the Contribution or Dependency Test and the Three Unities Test. I would excise them from the regulation and retain only the *Mobil* Factors Test (after making the changes in the description of that test which I will mention below).

The late Frank M. Keesling, who participated in both the *Butler Bros.* and *Edison California Stores* cases on behalf of the Franchise Tax Commissioner, wrote the following criticism of both the Three Unities Test and the Contribution or Dependency Test in 1960:

"Thus it is common to define a unitary business as one in which there is: (1) unity of ownership; (2) unity of use; (3) unity of management. These glib superficial phrases are at best ambiguous, if not actually meaningless. . . . In any event, the definition is of but little if any value since it fails to afford a hint or clue, let alone a reliable guide, for determining in particular cases which method of allocation should be employed.

"Another common definition of a unitary business is 'one where the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state.' This definition is a vast

improvement upon the one previously discussed. At least it recognizes that a business, to be unitary, must be conducted partly within and partly without the taxing jurisdiction. It is deficient however in that it does not clearly indicate that such a relationship to the Taxing jurisdiction is the sole criteria for distinguishing between separate and unitary businesses. Furthermore, the use of the word 'dependent' is confusing and misleading. Dependency suggests liability. If the activities within a given state are only dependent upon the activities out of the state, and do not contribute to the earning of income, they should not be credited with any portion of the income derived from productive activities outside the state."¹

I endorse these views completely.

Specific Criticism of the Three Unities Test

The Three Unities Test appeared in the last paragraph of the California Supreme Court's opinion in *Butler Bros.* as a sort of afterthought or summation of what had gone before. It was not an essential part of the opinion. The U.S. Supreme Court did not pick it up when it rendered its opinion in the case, nor to the best of my knowledge has that court ever applied the test in any of its subsequent decisions on state income taxation of multi-state businesses. Instead, the court has taken the more understandable approach that the draft describes as the *Mobil* Factors Test.

It is true that California Courts of Appeal, out of deference to their Supreme Court, have attempted to construct their opinions within the Three Unities Test (e.g., *Chase Brass*), and the California State Board of Equalization has boilerplate language about the test which it inserts into all of its unitary

¹ Keesling & Warren, *The Unitary Concept In the Allocation of Income*, 12 *Hastings Law Journal* 42, 47-48 (August, 1960)

business decisions. But in the more recent decisions of both tribunals, the test gets only an honorable mention as a lead-in to the opinion which thereafter ignores it.

The main point is that the test is simplistic, obscure, and just not helpful.

Specific Criticism of the Contribution or Dependency Test

This test was expressed in the *Edison California Stores* case in an attempt to improve upon the Three Unities Test, and indeed it is more meaningful. The problem with it is that it may lead us astray if we focus on the use of the disjunctive "or." Do we really want to say that activities within and without the state are unitary where the activities in the state are only dependent upon and in no way contribute to the activities in another state? How can this be reconciled with the stress given to "mutual interdependence" in later portions of the regulation? That term implies that contribution and dependency must flow in both directions.

Polishing the Mobil Factors Test.

To begin with, I think a better name should be found for the test. Although the *Mobil* case may have been the first in which the phrase "functional integration, centralization of management, and economies of scale" was used, the test is really drawn from a group of cases and not just from *Mobil*. In fact, the issue of unity wasn't even litigated in *Mobil*; and because it was not litigated, a whole array of dividends was allowed to be swept into the apportionment base without any evidence that the dividend payors were part of the taxpayer's unitary business (see footnote 9 to Justice Stephen's dissent). We would not want to create any impression that by attaching the *Mobil* label to the unitary business test the MTC is approving the outcome of that case in every detail. The *Mobil* label should be dropped from the title of the test.

The use of the word "factors" in the title and in the description of the test may cause confusion. Let's reserve "factors" for its statutory context, *i.e.*, the property factor, the payroll factor, and the sales factor. I suggest substituting "elements" for "factors" in this regulation.

I am also confused by the title appearing at line 130, "*Mobil* Factors Test Overall Test." Why does the word "test" appear twice?

Diverse Lines of Business

In II. B. of the draft, the sentence beginning on line 40 is obviously taken from Justice Brennan's opinion in *Container*, and it certainly deserves to be included in the regulation. However, I think a few words need to be added to carryout Justice Brennan's thought and make the sentence fully understandable. The middle of the sentence should read "the making of investments in another line of business." etc.

Presumptions

I wonder whether the things listed under IV. A. should really be called presumptions in the introductory paragraph. In existing Reg. IV. 1.(b). they are called "indicia" rather than presumptions, and "indicia" seems to fit better with the subsequent language. Business segments in the same general line "are generally engaged in a single unitary business." Segments engaged in different steps in a vertical process "are almost always engaged in a single trade or business." Diverse segments "are properly considered as engaged in one unitary business when" there is strong centralized management. Thus there seem to be different levels of persuasiveness in the three situations.

If they are to be presumptions then we must address the question of whether they can be invoked only by the state against the taxpayer or also by the taxpayer against the state. I think presumptions should work both ways.

This then leads me to question whether "business segments within a single business entity" (line 322) should be made a presumption at all. First, it doesn't appear in existing Reg. IV.1.(b). even as an indicia. Second, it debases II.D. of the draft. Third, if it is to cut both ways, as I think all presumptions should, then it will give taxpayers an opportunity to influence the result of a unitary business inquiry by choosing between the single-corporate and multi-corporate forms.