

INTERNATIONAL PAPER

INTERNAL MEMORANDUM OFFICE

TO : Paull Mines
FROM : Stephen Auster

DATE : October 23, 1997
CC : John S. Warren
Brian Toman

SUBJECT : Definition of a Unitary Business

Enclosed herewith are my comments together with some suggested changes to the Multistate Tax Commission's draft of the Definition of a Unitary Business.

I apologize for the delay in sending these written comments.

Stephen Auster

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The courts in determining whether or not a business is unitary have had difficulty in providing a realistic definition of a unitary business. Many courts have looked at the "three unities" test as set forth by the California Supreme Court in Butler Bros. v. McColgan, 17 Cal.2d 664, 111 P.2d 334(1941). The "three unities" as cited by the Court were (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation. These same courts have also looked at the contribution-dependency test as cited in the case of Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 P.2d 16 (1947). The test as cited by the court is, does one segment of the business contribute to or depend upon another segment of the business. More recently, state courts have relied upon the three criteria of functional integration, centralization of management and economies of scale as emphasized by the U.S. Supreme Court in Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980), ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982) and F.W. Woolworth v. Taxation & Revenue Department, 458 U.S. 354 (1982), or the declaration in Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983) that there be some sharing or exchange of value as evidenced by contributions to income resulting from functional integration, centralization of management and economies of scale. A unitary finding can be established under any one of the judicially acceptable tests and cannot be denied because another of these tests does not simultaneously apply. The difficulty with all these tests is that they are so vague that they can have different meanings for different courts when applied to similar fact patterns.

The three unities test of Butler Bros. has proven to be quite difficult for the courts to apply primarily because of the difficulty in determining whether a particular business attribute is unity of operation or unity of use. This is because there is a lack of a clear demarcation between these attributes. This has led to confusion and a lack of consistency in the courts' decisions. An example of this is, what distinction lies between management divisions which appears in the unity of operation test and a centralized executive force which appears in the unity of use test? It is also not clear how unity of operation as evidenced by central purchasing, advertising, and accounting is distinguishable from unity of use in the taxpayer's general system of operation. The one thing I do recognize from this test is that the attributes of common management (a centralized executive force) coupled with an operational interrelationship (central purchasing, advertising, accounting, and a general system of operation) are important indicia of a unitary business.

The contribution or dependency test of Edison Stores requires the examination of the operational interconnection of a purported unitary business. The test is extremely broad and allows many operational business attributes to fall within its ambit. The weakness of this test is its failure to precisely identify what elements are important to a unitary determination. The test is much broader than the three unities test because where the three unities test would determine an entity to be unitary, the contribution or dependency test would likewise find a unitary relationship. This is so because the contribution or dependency test only requires an operational interconnection (three unities test requires both an operational interrelationship (unity of operation) and common centralized management (unity of use)). It appears that the contribution or dependency test would permit a greater range of unitariness than found in the three unities test.

The functional integration, centralization of management, and economies of scale test of Mobil and Woolworth/ASARCO establish the constitutional limits of the unitary business principle. These elements have been reiterated in all of the most recent Supreme Court decisions on this topic. Some states have attempted to spell out limitations to the unitary concept by emphasizing the need for functional integration (i.e. a direct economic interrelationship between business segments with active management control) and limiting the effect of centralization of management and economies of scale or services (e.g., Illinois, Oregon, Arizona). The logical implications of this is that functional integration is an essential element of a unitary business. In the proposed diverse business regulations of the California Franchise Tax Board, it was stated that for a unitary business to exist there must be functional integration. The regulations stated that the integrating factors of importance were intercompany sales, common marketing, transfer of technical information, common distribution system, and common purchasing.

The judicial law also indicates that significant importance attach to centralized management (where management of the parent company is substantially involved in the actual operations of the subsidiary). Central management does not require that the activity constitute day-to-day management, but central policy making is sufficient. In Woolworth, the Court stated that central management is more significant as a unitary feature when such management is grounded in the parent corporation's own operational expertise and its overall operational strategy and where such management provides an operational role. The Mobil and three unities tests (unity of use of executive forces and general system of operation) require this in a unitary determination. However, the contribution or dependency test contains no specific requirement of central management and thus raises the question, is central management necessary where this test is utilized to determine the existence of a unitary business? Hence, will centralized management in the absence of functional integration support a unitary finding? Although centralization of management is a unitary factor, it must result in or contribute to the operational integration of the group to determine the existence of a unitary business finding.

State tax administrators have provided auditors with a checklist of unitary factors. The problem with these checklists is that all of the items tend to assume equal importance in making the determination. To demonstrate the existence of a unitary business, it is necessary to do more than to simply list circumstances which are labeled as unitary factors. Colorado R.S. 39-22-303(8) states that corporations may file a combined return if three of six unitary factors exist (intercorporate sales or leases, intercorporate services, intercorporate debts, intercorporate use of proprietary materials, interlocking directorates, and interlocking corporate officers).

In my opinion, the Mobil three factors test should be the primary test for determining a unitary business since it incorporates all the attributes of both the three unities and contribution or dependency tests. My suggestion would be to incorporate all the respective tests within the Mobil factors test (i.e. unity of operation of three unities test., operational interconnection of contribution or dependency test and functional integration of Mobil test under one criteria and unity of use of common centralized executive force of the three unities test and centralization of management of the Mobil test as a second).

Definition of a Unitary Business: Suggested Changes to the Wording
lines 85 through 303 only

- Line 85 The word "Tests" should be singular.
- Line 87 Eliminate the parenthetical. Add after the word value, " as evidenced by contributions of income resulting from functional integration, centralization of management and economies of scale."
- Line 92 Eliminate the entire sentence beginning with the word Evaluation.
- Line 95-97 Many states have determined that the use of investment funds for a business purpose is an operational versus an investment function and becomes part of your unitary income subject to apportionment. This is the "corporate riches" theory. In ASARCO, the Court stated that the use of funds in the business does not convert it to part of the unitary business. A reference of this statement is needed in this section.
- Line 100 The sentence should read, " Satisfaction of the following test will establish the existence of a unitary business: **Mobil Factors Test**. The enterprise's business segments exhibit functional integration, centralization of management and economies of scale. This test examines whether the business segments operate as an integrated whole or exhibit substantial mutual interdependence." I would eliminate Lines 103 through 109 and Lines 113 through 116 beginning with the words "See Reg. ***."
- Line 117 The sentence should read, "D. Analysis of the Test of a Unitary Business. The following analytical principles assist the application of the test described in III.C., above."
- Lines 120-129 Eliminate in its entirety.
- Line 130-139 Re-number as 1. Nothing is stated herein that all three factors of the Mobil Factors Test must be present in order to determine the existence of a unitary business.
- Line 140 Re-number as 2.
- Line 150 Re-number as 3.
- Line 153 Replace the word "significantly" with the word "substantially".

- Line 161 Insert after the word "isolation" the following: "Tests utilized by the courts in determining functional integration or operational interconnection are the contribution or dependency test and three unities test through its unity of operation. The contribution or dependency test is the operation of the portion of the business segment done within the state which is dependent upon or contributes to the operation of the business segment outside the state. In the three unities test there is unity of operation which is evidenced by central purchasing, advertising, accounting and management divisions."
- Line 165-169 Replace the word "indicate" with the following: "are important indicia of". The next sentence should read as follows: "The significance of intercompany sales will be a function of both the character of the items sold and the percentage of total sales or purchases represented by the intercompany sales. Intercompany sales of less than 10% are not considered significant."
- Line 175 Add another sentence which says, "Management or stewardship activities are not considered an intercompany sale or transfer of services (See discussion of centralization of management)."
- Line 176 Add the word "substantial" between the words "of" and "common".
- Line 177 Omit the words "is an indication" and substitute the words, "can be an important characteristic."
- Line 184 add after the word "enterprise" as part of the sentence the following: "and such common identification is a significant factor in purchaser's decision to purchase the respective products or services."
- Line 186 Omit the words "by itself establish" and insert the word "constitute".
- Line 190-194 I would reword this section as follows: "Functional integration may be evidenced by transfers or pooling of technical information, know-how or research and development if such transfers or pooling is important to the business segments' operations."
- Line 197 Delete the word "or" in the term "and/or".

- Line 205-213 Under the California proposed diverse business regulations, common or intercompany financing was not a determinative factor but instead was an additive factor. To date, there has been no case law to my knowledge that has found this criteria alone to support the finding of functional integration. This section should be deleted in its entirety or made a part of the "Other" section of vii below.
- Line 216 Delete the word "other".
- Line 242 Delete the word "other" at the end of the line.
- Line 247 Add the following: "A test utilized by the courts to determine the existence of centralization of management is the three unities test of its unity of use in its centralized executive force and general system of operation."
- Line 248 The first sentence should read as follows: "Centralized efforts to fulfill investment stewardship responsibilities such as implementation of a uniform system of internal controls or regulatory reporting requirements will not be determinative of centralization of management."
- Line 259 Insert after the word "implementing" the words "a uniform system of".
- Line 270 Delete the word "or" in the term and/or.
- Lines 266-272 Should state that this include that transfers of operational know-how and technical expertise.
- Lines 273-280 Delete section since I do not know why this is needed.
- Line 283 After the first word "operational" insert the word "and/or".
- Lines 290-293 Delete this section since covered under functional integration.
- Line 295 Insert the word "common" before the word "legal".