MINNESOTA Department of Revenue

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February 24, 1999

Mr. Alan Friedman
Special Counsel
Multistate Tax Commission
1040 Main Street
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Subject: Contribution/dependency test

Dear Mr. Friedman:

I am writing to you to recommend that the Multistate Tax Commission adopt a contribution/dependency test for determining a unitary business that continues to be in the disjunctive form. That is, the test should state, ". . .dependent upon **or** contributory to. . .".

Minnesota, like many states, has long had a disjunctive contribution/dependency test.[1] The statute states that:

> The term "unitary business" means business activities or operations which are of mutual benefit, dependent upon, **or** contributory to one another, individually or as a group. (Emphasis added)[2]

Replacing "or" with "and" will prevent states from combining many groups of corporations that have long been permitted to be combined under United States Supreme Court jurisprudence.

Vertically integrated businesses

Consider the example of a vertically integrated business in the oil industry that may have a number of corporations involved in the production, refining and sale of gasoline. For example:

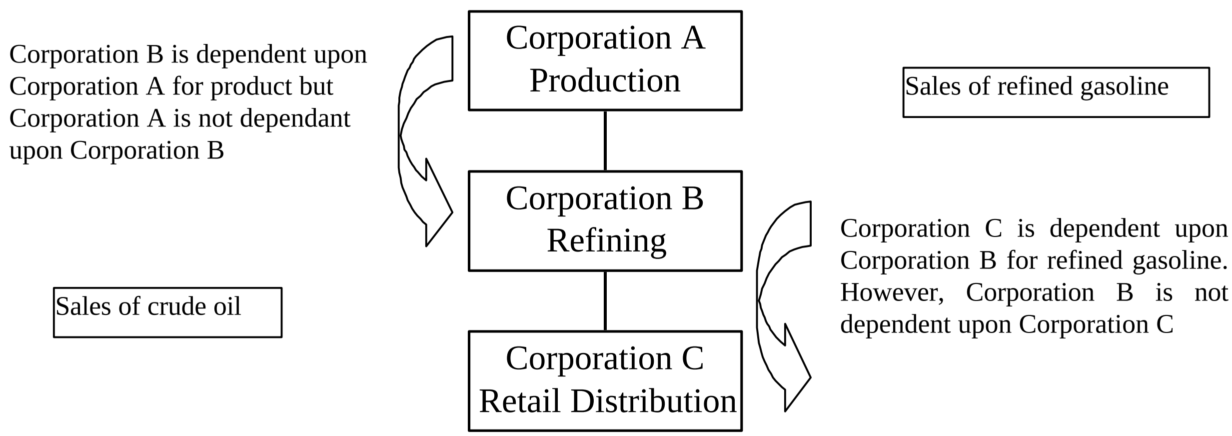
> Corporation A has oil wells in State # 1 that produce crude oil which is sold to Corporation B. Corporation B has a refinery in State # 2 that refines the oil acquired from Corporation A into gasoline. Corporation C

[1] This provision was enacted for earnings after December 31, 1981. *See* 1981 3rd Sp. Minn. Laws, Ch. 2, Art. 3, § 13.

[2] Minn. Stat. § 290.17, subd. 4 (b)

has retail gasoline stations in State # 3 that sells the gasoline produced by Corporation B.

In this example, Corporation C is dependent upon Corporation B for the refined gasoline and Corporation B is dependent upon Corporation A for its crude oil supply. However, it could be argued Corporation A is not dependent upon Corporation B or C and Corporation B may not dependant on Corporation C. Because these corporations form the steps in a manufacturing process conducted across state lines, it can easily be argued that these three corporations form an integrated unitary business. However, a conjunctive definition will make it difficult to reach that conclusion, even though this group of corporations should properly be taxed as a unitary business. The following diagram shows an example of a vertically integrated unitary business that is not dependent upon and contributory to one another.



A conjunctive test would require that, to have a unitary business the taxing authorities would have to show that Corporation A contributes to Corporation B and Corporation B is dependant upon Corporation A. In addition, under the conjunctive test the taxing authority would also have to show that Corporation B contributes to Corporation A and Corporation A is dependent upon Corporation B.

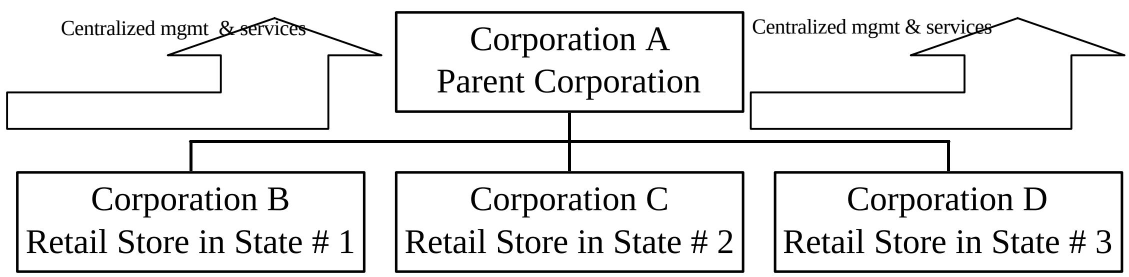
If we were to make the contribution/dependency test conjunctive rather than disjunctive, many of the unitary scenarios that are now clearly unitary under the United States Supreme Court's constitutional jurisprudence (such as the vertically integrated unitary business) would fail the statutorily defined unitary test. *See e.g.* Exxon Corp. v. Wisconsin Department of Revenue, 100 S.Ct. 2109, 2113 (1980).

Likewise, I think groups of corporations that would ordinarily be considered a unitary business under the three unities test, may not have the requisite mutual dependency of a conjunctive test.

Horizontally integrated business

For example, consider a group of corporations engaged in retailing. Corporation A, the parent corporation is has centralized management and centralized staff functions such a centralized purchasing, centralized payroll, centralized human resources department and other centralized functions. Corporation B operates a retail store located is State # 1, Corporation C operates a retail store located in State # 2 and Corporation D operates a retail store in State # 3. Under the three unities test, Corporation A through D would be considered as a single unitary business because the parent corporation exercises strong centralized management (unity of use) and there is centralized staff functions (unity of operation).

In such an example, each of the subsidiary corporations is dependent upon the parent corporation for centralized management and centralized services. However, the parent is not dependent on the subsidiaries for anything. Again to visualize this example, I have prepared the following diagram:



Because the subsidiaries do not contribute anything to the parent and the parent is not dependent upon the subsidiaries, this taxpayer presumably would not be considered a unitary business under a conjunctive dependency/contribution test.

Because the disjunctive form of this test has been the basis for numerous unitary cases since the 1950s[1] and because the disjunctive approach has not been reversed by the United States Supreme Court, I feel that states should continue using the disjunctive form of the definition.

[1] See Edison California Stores, Inc. v. McColgan, 183 P.2d 16, 21 (1947) (If the operation of the portion of the business done within the state is **dependent upon or contributes to** the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate.) (emphasis added)

If you have any questions or comments, please call me at (651) 282-5747.

Very truly yours,

/s/
William J. Lunka,
Corporate Technical Manager