Defining a Unitary Business: An Economist’s View, 30 Years Later

Charles E. McLure, Jr.

Based on article by the same title, State Tax Notes, September 20, 2014, pp. 875-904.
I. Preface: Some historical background

• “Unitary wars” of early 1980s – attempted extension to *Worldwide Combination*
• Hoover Conference: November 1982
• 1984 publication: *Issues in Worldwide Unitary Combination*
• My 1984 paper: An economist’s view of what constitutes a unitary business
  – Dissatisfaction with legal tests (*Butler Bros.*, *Edison Stores*)
  – *Exxon, Mobil, ASARCO, Woolworth* barely discussed
Historical background, continued

- My 2014 STN paper: an update, based on further thinking and experience
  - Important Supreme Court cases defining unity
    - Only brief discussion of Exxon, Mobil, ASARCO, Woolworth
    - Subsequent cases: Container, Allied-Signal, MeadWestvaco
  - Further analysis, due to participation in Comcast
  - Examination of unitary definitions in MTC and California regulations
- I know of no literature disputing my earlier views
- This is really an elaboration of those views
II. Introduction

• A. The Need to Define a Unitary Business
  – Separate accounting/arm’s-length pricing (SA/ALP) fails, if economic interdependence is pervasive
  – Alternative is unitary combination/formula apportionment (UC/FA)
  – *Mobil*: “the linchpin of apportionability . . . is the unitary business principle”
  – *Exxon, ASARCO, Woolworth, Container, Allied-Signal,* and *MeadWestvaco* also hinged on existence of a unitary relationship
Introduction, continued

• Results of both SA/ALP and UC/FA commonly are, to some extent, arbitrary

• Courts should endorse the approach likely to give the more accurate division of income between affiliated entities

• My basic test of unity is whether, within a reasonable degree of accuracy, SA/ALP can isolate the profits of individual entities
  – If not, the entities are engaged in a unitary business
  – SA/ALP is default method
Introduction, continued

• Common control is required to find that a unitary business (enterprise unity) exists
  – Total autonomy of individual entities generally indicates the absence of unity
  – Common ownership often, but not always indicates common control
    • I ignore question of common ownership here
• For convenience, what follows initially assumes common control
III. Vertical Transactions

• \textit{Vertical transactions} ≠ \textit{Vertical integration}

• Two types of problems:
  – Vertical transactions, with no other significant economic interdependence
    • “Income division”: slicing a pie of a given size
    • Transfer pricing is the key issue
  – Pervasive economic interdependence
    • “Income division with synergy”: economic interdependence increases size of the pie
    • Transfer pricing is not the only problem or solution
Vertical Transactions Where Transfer Pricing is the Only Issue:1

• Other economic interdependence is insignificant
• Accurate income division is knowable in principle, if not in practice
• I. Readily knowable competitive prices ⇒
  • SA/ALP can give the right answer
    – Section 482 analysis based on comparable uncontrolled prices
  • Are transactions quantitatively significant?
    – No: ⇒ SA/ALP
  • Are transactions fully compensated?
    – Yes ⇒ SA/ALP
  • Administrative considerations may suggest UC/FA
Vertical Transactions Where Transfer Pricing is the Only Issue: 2

II. Comparable uncontrolled prices do not exist
   – E.g., Affiliate A sells only to Affiliate B
   • Accurate income division can be extraordinarily difficult
   • SA/ALP is employed internationally
     – Administrative complexity is notorious
     – UC/FA is a reasonable alternative, unless
       • Transfer prices are easily determined to be ALP
       • Errors in SA/ALP could not be quantitatively significant
Vertical Transactions Where Transfer Pricing is the Only Issue: 3

• Flows of value that are clearly fully compensated are irrelevant from an economic point of view
  – There are flows of value between economically interdependent independent entities that are interdependently owned
  – These are fully compensated
  – Income division is accurate
  – The same is true of related entities, if flows of value are fully compensated
  – Administrative considerations may suggest UC/FA
Vertical Transactions Where Transfer Pricing is the Only Issue: 4

• The view from the U.S. Supreme Court
  • *Container*: “The prerequisite to a constitutionally acceptable finding of a unitary business is a flow of value, not a flow of goods.”
  • Easily misinterpreted to mean that is irrelevant whether flows of value are compensated
  • But: *Container* refers to “… sharing or exchange of value not capable of precise identification or measurement …”
  • In *Allied-Signal*, the Court said, “*Container Corp.* clarified that” functional integration could be shown by “transactions not undertaken at arm’s length.”
  • Implication is clear — arm’s-length transactions do not provide evidence that there is a unitary relationship
Vertical Integration

• Economic interdependence is pervasive
  – “Income division with synergy”
• Accurate division of income is, in principle, unknowable
• UC/FA is required
  – But not if economic interdependence is insignificant
• Reasons for vertical integration *p. 882
  – Difficulties in contracting
    • Especially important where information is concerned
      – Value of information is known only after it is acquired
      – No need to pay for information, once it is acquired
  – Economies of scale: increase in output exceeds increase in inputs (e.g., doubling diameter of tank quadruples capacity)
Horizontal Economic Interdependence: I

• Synergism generally explains horizontal integration
• Economies of scale, e.g., in purchasing, warehousing
• Economies of scope: producing or selling two or more products jointly costs less than producing or selling them separately
• Interdependence in demand
  – Complementary products (e.g., razors and blades)
  – Substitute products (e.g., fuel oil and coal)
  – Relevant only if product markets are not competitive
    • Competitive firms are price-takers in both markets
Horizontal Economic Interdependence: II

• Advertising and public relations
  – Benefits of brand loyalty cannot be divided among products of the advertiser

• Market sharing by affiliated firms
  – Division of sales (and perhaps costs), and thus profits, among the entities – and thus the states -- is under common control

• Reciprocal buying
  – Entity A buys from Entity B if Entity B will buy from Entity C, an affiliate of entity A

• Risk-taking: Risks taken by Entity A may reduce risks taken by Entity B (e.g., R&D and exploration for oil)

• UC/FA may be appropriate in all these cases
The Importance of Common Control

• Common control is required for a finding that a unitary business (enterprise unity) exists.
• If a group of affiliated entities is to form a unitary business, it must be operated that way.
• FTB audit manual:
  – A centralized executive force will … ensure that they are operated in a manner that will be most advantageous to the unitary business as a whole. [This] … may be contrasted with a situation where common officers and directors are concerned only with maximizing the profitability of each individual corporation but without regard to each corporation’s role in the group as a whole.
The relevant kind of control

• Control of the strategic and operational decisions of affiliates
  – *Mobil:* “centralized management.”

• Two irrelevant types of control
  – Control of the kind any corporate parent exercises over its subsidiaries
    • Absence suggests lack of centralized management
  – Management of only subsidiary’s day-to-day operations
The Need for De Minimis Rules

- For a finding of unity, uncompensated and unaccountable flows must be substantial enough to cause SA/ALP to fail badly.
- “De minimis, relative to what? Relative to the difference in apportionable income attributed to these entities under SA/ALP and UC/FA.”
De Minimis Rules, continued

• De minimis rules would not weaken the unitary business principle
  – To apply when there are only minor unallocable costs, small potential errors in transfer prices, and little or no other significant unaccountable flows of value resulting from economic interdependence
## Summary: Four-Stage Test of Unity

| Test 1: Is there common ownership? (ignored here) | No: Non-unitary | Yes: Apply test 2 |
| Test 2: Is there common control (centralized management)? | No: Non-unitary | Yes: Apply test 3 |
| Test 3: Are there “unitary links?” (defined separately) | No: Non-unitary | Yes: Apply test 4 |
| Test 4: Are these “unitary links” substantial? | No: Non-unitary | Yes: Unitary |
Test 3: Unitary Links

• Test 3: Are there:
  • horizontal or vertical integration,
  • shared expenses or economies of scale or scope,
  • intragroup transactions that cannot easily be valued, or
  • other uncompensated or unaccountable flows of value resulting from economic interdependence that depend on common ownership and control
SA/ALP Cannot Impeach UC/FA For a Unitary Business

• Suggesting that SA/ALP can impeach the results of combination because it produces less taxable income has no basis in logic
• If the predominance of evidence shows that the 4-part test is satisfied, UC/FA is appropriate
• If not, SA/ALP is likely to measure income more accurately than UC/FA
• In that case, there is no unitary business and SA/ALP should be employed
Four Extensions of the Analysis: I, The irrelevance of pre-acquisition relationships

- Economic interdependence/flows of value existing before majority ownership and continuing unchanged cannot indicate that a unitary business exists after acquisition
  - They do not depend on common ownership and control
  - They can indicate the absence of unity
- Post-divestiture relationships are similarly irrelevant
Four Extensions of the Analysis: II, “Instant unity” -- ordinarily an empty box

“Unity except for ownership and control” is a contradiction in terms, because common control is required for a finding of unity

• “Instant unity” — attaining unity immediately upon achieving common ownership — occurs rarely, if ever

• Application of UC/FA based on instant unity can create substantial overstatement of apportionable income (see example in article)
Four Extensions of the Analysis: III, Gross or net flows of value?

• The finding of a unitary business should be predicated by the existence of gross uncompensated flows of value between affiliated entities, not net flows

• Net flows of value may be small, because flows of value in one direction may offset flows in the other direction
  – It would also be difficult to calculate net flows
  – It is only necessary to identify significant sources of gross flows
Four Extensions of the Analysis: IV, The direction of uncompensated flows of value

• UC/FA could distort the division of income between entities if one entity depends on another but does not contribute to it
  – Consider two entities: H (high profits) and L (low profits)
  – UC/FA attributes some of profits of H to L
  – Appropriate if L contributes significantly to H
  – Inappropriate if L only depends on H
  – Recognized by Keesling and Warren
Tests of Unity in Court Decisions

• Four “shorthand tests of unity”
  – “Three unities” (ownership, operation, and use) -- Butler Bros. (1941);
  – “Contribution or dependence” -- Edison Stores (1947);
  – “Functional integration, centralization of management, and economies of scale” -- Mobil (1980);

• These tests of unity are quite different
Tests of Unity in Court Decisions I: The *nature* of a unitary business

• “Contribution or dependence” and “flow of value” describe the *nature* of a unitary business

• While evocative, these tests are nebulous and subjective and difficult to implement
  – Hellerstein and Hellerstein: “However instructive the foregoing definitions may have been in providing a general description of a unitary business, they offered little practical guidance for resolving unitary business controversies.”

• No distinction between compensated and uncompensated flows of value

• No mention of common control
Tests of Unity in Court Decisions II: *attributes* of a unitary business

• “Three unities” and *Mobil* test describe *attributes* of a unitary business
• More objective basis for legal tests of unity
• Emphasis on common control *(and, in *Butler Bros.*, common ownership)*
• Conclusion: the three unities and the *Mobil* indicia constitute a test of unity, but “contribution or dependency” and “flow of value” do not
Tests of Unity in Court Decisions III: Supreme Court jurisprudence

• In *Allied-Signal* the Court clearly emphasized the Mobil indicia as the test of a unitary relationship:

  – In the course of our decision in *Container Corp.*, we reaffirmed that the constitutional test focuses on functional integration, centralization of management, and economies of scale. . . . We also reiterated that a unitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities.

• It did not similarly suggest that “flow of value” is a test of unity; it mentioned it only to contrast it with a flow of goods, the bright-line test proposed by the taxpayer
Tests of Unity in Court Decisions IV: Judicial Tests of Unity appraised
Tests of Unity in Court Decisions, V: Necessity and sufficiency of unitary *indicia*

- Supreme Court has never said which indicia are necessary and which are sufficient for a finding of unity
  - *Butler Bros* and *Mobil* list 3 indicia
- My view:
  - Common control is necessary for unity, but is not sufficient
  - No other indicia is either necessary or sufficient
Tests of Unity in Court Decisions, VI: Necessity and sufficiency of unitary tests

• FTB claims satisfaction of any of the 4 tests is sufficient
• I believe this is wrong
  – Neither “contribution or dependency” nor “flow of value” is test of unity
  – US Supreme Court has never sanctioned contribution or dependency
  – Mobil supersedes Butler Bros.
  – Satisfying Mobil is both necessary and sufficient
Unity in California Law and Practice

• California’s law, FTB, BoE, and courts exist in a parallel universe not governed by the decisions of the U.S. Supreme Court
  – California relies almost entirely on three unities and contribution or dependency
    • Barely acknowledges existence of *Mobil* indicia
  – Since 1980 the U.S. Supreme Court has relied exclusively on the *Mobil* indicia
    • None mentions *Edison Stores* or relies on contribution or dependence as a test of unity
California Law and Practice, II

• California regulations
  • MTC regulations but provide no interpretive guidance
    – Based on contribution or dependency
    – Meeting any one of 3 criteria is sufficient for a presumption of unity:
      • Same line of business
      • Steps in a vertical process, even if the various steps are operated substantially independently
      • Strong centralized management, with centralized departments for functions such as financing, advertising, research, and purchasing
Flaws in California regulations

• Meeting only one of the 3 criteria should not be sufficient for a presumption of unity
• Vertical processes ≠ vertical integration, without centralized management
• “The presumption of unity may only be overcome with evidence that the activities are not unitary under any of the established tests (for example, three unities, contribution or dependency).” -- FTB audit manual
  – No mention of Mobil indicia
Summary of Crucial Conclusions

• Common control is required for unity
• There must be concrete, objectively identifiable attributes of unity ("unitary links")
  – E.g., shared expenses, economies of scale and scope, horizontal and vertical integration, transfer prices not easily shown to be ALP
• Unitary links must not be de minimis
• This test is generally consistent with Supreme Court jurisprudence since 1980 based on *Mobil*
• The Court should say explicitly whether each of the *Mobil* indicia is necessary or sufficient for unity