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

Charles E. McLure, Jr.

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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

- *Vertical transactions ≠ 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., (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);
  - ‘‘Flow of value’’ -- C*ontainer* (1983)
- 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 t*he 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