I. Introduction

This article is the first of our new series regarding common issues and opportunities associated with combined reporting. Because most states either statutorily require or permit some method of combined reporting, it is important for taxpayers to understand the intricacies of and opportunities in combined reporting statutes and regulations.

In this article, we will explore the foundation for combined reporting — the unitary business principle. The unitary business principle finds its roots in 19th-century property taxation, when the U.S. Supreme Court first observed that an integrated business should be taxed as one unit instead of separately accounting for its component parts.

The unitary business principle plays an important role not only as a criterion for combined reporting, but also as a touchstone for a state’s ability to tax extraterritorial values. The application of the unitary business principle in the combined reporting context can be fairly straightforward when dealing with a clear vertically integrated business (e.g., a group of affiliated entities engaged in manufacturing, distribution, and sales of the same products) but is complex in situations in which the relatively simple vertically integrated business has been replaced by diverse portfolios of investments that include companies engaged in very different lines of business.

II. Historical Development of the Unitary Business Principle

To fully understand the unitary business principle, it is important to review its historical underpinnings and development through Supreme Court precedent. While the unitary business principle was developed in the property tax context based on physical unity, it was easily adapted and applied within the corporate income tax context to operational unity—first, as a mechanism to appropriately apportion a corporation’s multistate operations, and then expanded to tax the income of several corporations engaged in a unitary business enterprise through combined reporting.

The Supreme Court has since ordained the unitary business principle as the “‘linchpin of apportionability in the field of state income taxation.”

A. Early Cases

The unitary business principle originated in the United States in the 19th century with state property taxes and transcontinental railroad and express companies. The issue in those early cases was whether a jurisdiction could tax only the value of a company’s property physically located within its borders (for example, the value of an isolated piece of railroad track) or an apportioned share of the value of the company’s entire system (for example, an apportioned share of the value of a transcontinental railroad system), in which the value of the whole system was greater than the sum of its parts. As noted in 1875 in State Railroad Tax Cases, the “‘theory of the system is manifestly to treat the railroad track, its rolling stock, its franchise, and its capital, as a unit for taxation, and to distribute the assessed value of this unit accordingly as the length of the road in each county, city, and town bears to the whole length of the road.”

In Adams Express Co. v. Ohio State Auditor, the Supreme Court upheld the application of the unitary business doctrine in a property tax context to include an express company’s intangible property. In Adams Express, the taxpayer argued that the state could take into consideration only those items of property physically located
The state argued that it had the right to impose tax on an apportioned part of the business’s entire property because that property was economically interrelated and inseparable from its combined value. Finding no real difference between the express company’s assets (such as horses, wagons, and facilities contracts) and those of railroad or telegraph companies, the Supreme Court stated that “the property of an express company, distributed through different states, is an essential condition of the business united in a single specific use. It constitutes but a single plant, made so by the very character and necessities of the business.” Because items of property located in different states were operated as part of a single unit or in a unitary fashion, imposing tax through a “separate accounting” for each item of property was not required.

It was a simple matter for states to transfer this unit concept to the corporate income tax when they began taxing corporate income in the early 20th century. The states adapted the formulary apportionment method developed for property tax purposes to the corporate income tax. This adaptation was upheld by the Supreme Court in Underwood Typewriter Co. v. Chamberlain. In Underwood Typewriter, the Court concluded that a state tax on business income, which apportioned to the state a percentage of a corporation’s total net income equal to the portion of the corporation’s real and tangible personal property located within the state as compared to its total of all such property in all states, is valid under the due process and commerce clauses. The Court noted that the “profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states.”

The Court also wrote that “faced with the impossibility of allocating specifically the profits earned by the processes conducted within [Connecticut’s] borders,” the legislature “adopted a method of apportionment which . . . reached, and was meant to reach, only the profits earned within the state.” Not only did Underwood Typewriter affirm application of the unitary business principle to corporate income taxes, it also expanded the concept of operational unity to a vertically integrated business.

While states initially applied the unitary concept to determine the share of income earned in the state by a single company, the principle was extended in later years to determine the share of income earned in the state by a multiple-entity unitary business. Just as the transcontinental railroad has value as an integrated unit, so does a multistate business—leading to the dawn of unitary combined reporting.

B. Accepted Tests for Unity

It is helpful to look to California for a definition of the term “unitary business” because it was the first state to adopt unitary combined reporting. In 1942 the California Supreme Court enunciated a three-part test, known as the three unities test, for determining the existence of a unitary business. Under this test, a unitary business must exhibit unity of ownership, operation, and use. Five years later, the same court set forth the “contribution or dependency test.” Under this test, if the operation of a portion of the business done within the state depends on or contributes to the operation of the business outside the state, the operations are unitary; otherwise, if there is no such contribution or dependency, the business within the state may be considered to be separate.

In 1980, decades after California paved the way, the Supreme Court set forth its views of a unitary business in Mobil Oil Corp. v. Commissioner of Taxes of Vermont. In Mobil Oil Corp., the Court upheld application of the unitary business principle as justification for inclusion of dividend income from foreign affiliates in the apportionable business income of a New York company with wholesale and retail marketing activities in Vermont. In so holding, the Court found that the in-state and out-of-state activities form part of a single unitary business. The Court wrote that:

separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable ‘source.’

In the context of combined reporting, the Supreme Court later stated that the “prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods” as evidenced by the components of the Mobil test (i.e., functional integration, centralization of management, and economies of scale), which are now known as the “hallmarks” of a unitary business. Indeed, some state legislatures have adopted tests for a unitary business that are identical to the Mobil test for purposes of their combined reporting statutes. Also, while the states retain the freedom to define a unitary business, that freedom is limited by the constitutional principles that the Supreme Court has articulated in delineating the scope of a unitary business — something that many states have forgotten (as discussed below).

III. Common Issues in the Application of the Unitary Business Principle
Today, 25 jurisdictions mandate unitary combined reporting for general corporations that are commonly owned or controlled. Those states that require unitary combined reporting employ varying definitions of what constitutes a unitary business. Application of these different approaches involves highly fact-intensive examinations that often lead to divergent results. Below we will explore the most common issues our clients face in applying tests for unity.

A. Actual Control

Taxing authorities frequently assert that if a company has the potential to control another company (through majority ownership), this alone is indicative of a unitary business. This assertion is particularly frustrating for taxpayers because Supreme Court precedent clearly establishes that an actual exercise of control, as opposed to simply the potential to control, is essential to a finding of a unitary relationship.

In ASARCO Inc. v. Idaho State Tax Commission, the Supreme Court relied heavily on the lack of actual control in concluding that ASARCO was not engaged in a unitary business with its subsidiaries. In ASARCO, the Supreme Court observed that because ASARCO owned more than a majority of one of its subsidiaries, it could have controlled the company’s management. However, because the other three stockholders of that subsidiary refused to participate in the arrangement “unless assured that they would have a way to assure that management would not be completely dominated by ASARCO,” ASARCO entered into a management contract giving ASARCO the power to designate only six of the 13 directors. In addition, the corporate bylaws for that subsidiary required the consent of at least eight directors to pass any resolution.

In view of these facts, the trial court found that the management contract ensured that ASARCO could not actually control the subsidiary and that the subsidiary operated independently of ASARCO. As a result, the Supreme Court held that the two businesses were “insufficiently connected to permit the two companies to be classified as a unitary business.”

The Supreme Court similarly found that ASARCO’s relationship with its other four subsidiaries fell far short of creating a unitary relationship. Another subsidiary that was 52.7 percent owned by ASARCO failed the test because “although ASARCO has the control potential to manage [the subsidiary], no claim is made that it has done so.” The Supreme Court thus reaffirmed the principle that the exercise of actual control of a subsidiary, as distinguished from the potential to control the company, is a prerequisite of a unitary business relationship.

Similarly the Supreme Court found a lack of a unitary relationship in F.W.Woolworth Co. v. Taxation and Revenue Department of New Mexico. In Woolworth, the parent company had the majority or complete ownership of several foreign subsidiaries and consequently had the power to control the subsidiaries. However, the parent did not actually exercise control, instead allowing each of the subsidiaries to operate autonomously. As later explained by the Supreme Court in Allied-Signal, “We observed in Woolworth that although the parent company had the potential to operate the subsidiaries as integrated divisions of a single unitary business, that potential was not significant if the subsidiaries in fact comprise discrete business operations.”

The Court made it clear in Allied-Signal that “potential control” is not sufficient to support a finding that a unitary relationship exists.

The distinction between actual versus potential control notwithstanding, many revenue authorities view the ownership requirement for purposes of filing a unitary combined return as a proxy for the control required to satisfy the unitary business test. While it is not entirely unreasonable to speculate that a corporation that is majority-owned or even wholly-owned by another corporation is engaged in a unitary business, such speculation cannot be substituted for an actual review of the relationship between those entities. If it is clear that the corporations have separate management and that the subsidiary can and does make independent decisions, it may be much more difficult to establish the existence of a unitary relationship between those entities.

For example, in Comcon Production Services Inc. v. FranchiseTax Board, the California Superior Court determined that Comcast, a parent company that operated a cable network, was not unitary with QVC, a company that operated a retail shopping channel. Comcast owned a majority of the interests in QVC, and Comcast’s cable network had an agreement under which it broadcast the QVC shopping channel to Comcast’s subscribers. The court found that none of the indicia of a unitary business set forth by the U.S. Supreme Court in Mobil was present because the evidence showed there was no centralized management, no functional integration, no economies of scale, and no other non-trivial alleged flows of value. Specifically, the court reiterated that mere potential to control another commonly owned company is not evidence of a unitary business — actual control is required.

B. Instant Unity

One of the biggest questions that arise in the context of acquisitions is when the acquired and acquiring companies are permitted or required to file a unitary combined return. Taxpayers may want to take the position...
that the acquired company can be included in the combined return on the date of acquisition. This is often referred to as instant unity. It may be particularly beneficial for taxpayers to claim instant unity when an acquired company has losses.

California is one state that has embraced the concept of instant unity when there is evidence of a preexisting relationship between the companies. In Appeal of Atlas Hotels Inc. and Picnic ‘N Chicken Inc., the State Board of Equalization concluded that a taxpayer engaged in a unitary hotel business was immediately unitary with a corporation that owned and operated a chain of fast-food outlets that it acquired. The BOE’s finding was based largely on the following facts: (1) two of the hotel’s top executives assumed positions as the top executives of the fast-food company; (2) there were immediate, substantive changes to the overall operating philosophy of the fast-food chain; (3) several service functions were combined; and (4) there was substantial intercompany financing and product flow between the two companies. Many of the decisions relating to the substantial changes in the fast-food company’s business operations were made well in advance of the acquisition date so they could be implemented on acquisition.

Similarly, in Appeal of Dr. Pepper Bottling Co. of Southern California, the BOE determined that a soft drink bottler was instantly unitary with Dr. Pepper Co., a corporation that manufactured and distributed soft drink concentrates and syrups. Again, the companies had a preexisting relationship.

The bottler had been a licensee of Dr. Pepper Co. for many years before the acquisition, and over 50 percent of its concentrate and syrup purchases were from Dr. Pepper. Generally, instant unity is easier to establish when there is some evidence of a preexisting relationship between a newly acquired subsidiary and its parent. When such a relationship is absent, a taxpayer will have to show immediate flows of value. In U.S. Bancorp and Subsidiaries v. Department of Revenue, the Oregon Tax Court held that two newly acquired banks were unitary with their new parent at or near the date of acquisition based on what the court perceived were immediate flows of value between the businesses. The court noted that the parent’s size and financial strength immediately created a flow of value to the newly acquired banks, such as increased credit lines that enabled them to meet the needs of larger corporate business. The acquisition also resulted in savings of over $1 million a year in insurance premiums and allowed the parent to reach into new markets.

The court relied on these flows of value as justification for taxing the businesses as a unit as of or near the acquisition date.

While a few states have specific guidance on determining when the integration between two companies has developed to the point that a unitary finding is appropriate, most do not. Instant unity cases tend to be very fact dependent. Because of the fact-intensive nature of the instant unity question, companies should analyze and document premerger and post-merger activities to sufficiently support their positions. Companies wishing to establish instant unity with a newly acquired company should consider taking the following actions:

• Establish an integration plan in advance of the acquisition. The acquiring company should establish a plan for immediately integrating its operations with those of the acquired company and should document those plans.

• Replace officers and directors. The acquired company’s officers, directors, and key managers should be immediately replaced with individuals from the parent corporation (or from one of its existing subsidiaries).

• Control the acquired company’s management decisions. Often the parent company makes management decisions well before it acquires the company. Carefully document management decisions to proceed with operations as currently planned or to discontinue operations.

• Centralize administrative functions. Centralizing functions such as human resources, legal, accounting, benefits, sales, purchasing, and information technology will assist in evidencing a unitary relationship.

• Adopt consistent company policies. The parent company should immediately impose its policies and procedures on the newly acquired company.

• Consider intercompany financing arrangements. Entering into intercompany financing arrangements will demonstrate a flow of value if the parent company can show that the funding achieves functional integration or economies of scale.

C. Holding Companies

Another issue frequently presented by taxpayers is whether a holding company is engaged in a unitary business with its subsidiaries. A holding company may be entirely passive or provide some management and oversight to
its subsidiaries. But in most cases, the activities of the holding company are of a limited nature.

Some states specifically address whether a passive holding company will be deemed to be included in a unitary business with its subsidiaries. For example, Wisconsin states in its regulations that a passive parent holding company that directly or indirectly controls one or more operating company subsidiaries engaged in a unitary business will be deemed to be engaged in the unitary business, even if the holding company’s activities are primarily passive. Further, a passive holding company that is in a commonly controlled economic enterprise that holds intangible assets that are used by the enterprise in a unitary business will be deemed to be engaged in the unitary business. By regulation, New York had historically excluded pure holding companies from its combined returns on the basis that such companies are not conducting a unitary business. However, it remains to be seen whether this interpretation will continue after New York’s substantial overhaul of its corporate franchise tax, including its combined reporting regime, in 2014.

The Illinois statute that defines the term “unitary business group” also defines “holding company” and addresses issues relating to holding companies that are members of more than one unitary business group, but it does not provide guidance on whether a holding company will be deemed to be engaged in the unitary business. Illinois taxpayers must review case law in making such determinations.

In Shaklee Corp. v. Dept. of Revenue, the Illinois Appellate Court held that the holding companies and the taxpayer (the parent company) were engaged in a unitary business because they had common ownership, were engaged in functionally integrated lines of business, and shared management services. In holding that the holding companies were functionally integrated with the taxpayer, the court ruled that the holding companies were in the same line of business, despite the taxpayer’s assertions to the contrary.

A number of other state courts and administrative bodies have addressed this issue with inconsistent results. For example, in the Appeal of Insul-8 Corp., the BOE held that a passive holding company was not engaged in a unitary business with its operating subsidiary because the centralized management cited by the taxpayer was merely commonality of officers and directors. The BOE concluded that because there were no operations in the holding company to manage, it was meaningless to speak of centralized management.

Moreover, the BOE held that the mere use of profits of one corporation to pay the debts of another related corporation does not indicate the existence of a unitary business. However, the BOE did find that a passive holding company was engaged in a unitary business with its operating subsidiary in the Appeals of PBS Building Systems Inc. The BOE based its decision on (1) the complete overlap of officers and directors; (2) extensive intercompany financing consisting of loans, loan guarantees, and debt financing; and (3) a covenant not to compete purchased by the holding company for the benefit of the operating subsidiary. The BOE rejected the FTB’s position that passive holding companies are per se non-unitary.

Although the case did not involve combination, the Tennessee Supreme Court has held that a passive holding company, which did not conduct any business of its own, was unitary with a limited partnership based on the fact that both entities “derive their income from a single underlying activity.”

While the question whether a passive holding company will be deemed to be part of a unitary business is unsettled, states lean toward inclusion, particularly when a parent holding company controls major corporate decisions of the subsidiary relating to strategy, budgets, and expenditures. Opportunities may exist for taxpayers with different fact patterns hoping to avoid combination. D. Use of Discretionary Authority to Permit or Require Unitary Combined Reporting Although 25 states require unitary corporations with common ownership to file a combined return, there are also states where combination may be required (or permitted) in some circumstances (typically if a taxpayer conducts non-arm’s-length or other distorting transactions with its affiliates), and there are still states that do not expressly allow for the filing of unitary combined returns in any circumstances. In the last two categories of states, the question becomes whether a group of commonly owned entities that engage in transactions that create flows of value can request permission to file or be required to file a combined return.

Many states that require separate company returns provide discretionary authority to the tax administrator, either by statute or regulation, to make adjustments to accurately reflect the income earned in that state, including forcing unitary corporations to file combined returns. Many of those provisions also permit corporations to proactively request an alternative filing method, such as a combined return, to more accurately reflect their income. In recent years, those provisions have been increasingly used by state revenue authorities to require corporations to file on a combined basis.

Even absent a specific grant of discretionary authority to require or permit the filing of unitary combined returns, state revenue authorities and taxpayers can premise a request for combined reporting on (1) a state’s alternative apportionment statute, which is typically modeled after section 18 of the Uniform Division of Income for Tax Purposes Act and which usually allows for the use of any other method (which taxpayers and revenue authorities in some states have successfully argued should include unitary combined reporting) to accurately
reflect income in the state, or (2) the logic articulated in Edison California Stores.

In Edison California, a Delaware corporation owned a chain of retail stores selling shoes and accessories. Each store was organized as a separate subsidiary in the state in which it did business. The parent company manufactured no goods but conducted central management, purchasing, distributing, and advertising for all the stores outside California. The California subsidiary, which carried on a purely intrastate retail business, paid for the goods and services received at the parent company’s cost, plus a share of that company’s overhead charges. The California subsidiary sought to have its franchise tax, which was measured by apportioned net income, determined under a separate accounting method. The California commissioner rejected this and instead applied a formula made up of three factors —property, payroll, and sales—to the income of the entire group of corporations in computing the net income of the California subsidiary apportionable to the state. In upholding the California commissioner’s approach, the California Supreme Court held that the power to require combined unitary reporting flows not from the power to require consolidated returns, but instead from “the authorized method of ascertaining the income attributable to a taxpayer’s activities within the state.” The court in Edison California held that such a power may be used when the accounting system of the taxpayer does not clearly reflect income, “which may be the case when it is part of a unitary system.”

Thus, permission to file or a command to file on a combined basis often hinges on the existence of the essential unitary business characteristics — unquantifiable flows of value and interdependence that must be taken into account for purposes of measuring the taxable entities’ income attributable to, and thus, taxable by, the state.

E. Affiliated Group Elections

For purposes of filing a unitary combined return, the composition of a unitary group (or multiple groups for large multinational corporations) is premised on a highly subjective facts and circumstances analysis that looks to factors such as functional integration, economies of scale, and centralization of management. In sharp contrast, the federal consolidated group’s composition is determined based on a single objective criterion — ownership (affiliation).

Thus, there is a clear appeal to a state election that would permit a corporation to report income based on a similar affiliated group concept.

Affiliated group elections are not necessarily new, even though they have received increased attention as the most recent states to enact unitary combined reporting legislation, New York and Rhode Island, have included provisions for affiliated group elections. For example, in Rhode Island, an affiliated group of C corporations may elect to be treated as a combined group regardless of whether they are engaged in a unitary business. The election is premised on the condition that all members of the affiliated group consent to be included in the group and that it may not be revoked in less than five years without the approval of the Rhode Island Division of Taxation. New York’s law contains a similar provision, except the election is binding for seven years.

While, as discussed above, the clear appeal of such elections is certainty and administrative ease, removing the need to analyze the highly subjective unitary hallmarks, given that these elections are often binding for several years, taxpayers must proceed with caution and carefully analyze the implications of such an election, particularly if an acquisition path is forecast as these elections typically bind newly acquired entities.

IV. Conclusion

Even though almost half of the states require combined reporting for companies engaged in a unitary business, most do not provide clear guidelines as to when a unitary business exists. Unitary determinations are often unpredictable given their fact-intensive nature. Auditors typically assert the finding of a unitary business to increase taxable income and deny the finding of a unitary business when it decreases taxable income. Taxpayers should be thinking along the same lines in identifying opportunities and establishing filing positions.

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