Application of the Unitary Business Concept to Diverse Businesses: Light at the End of the Tunnel or the Impossible Dream?

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Application of the Unitary Business Concept to Diverse Businesses: Light at the End of the Tunnel or the Impossible Dream?

The limit to which states may tax the multijurisdictional activities of corporations has been the subject of much litigation and vigorous debate for many years. At the heart of the debate is the problem of assigning the appropriate amount of income to each state in which the corporate taxpayer conducts business activities. Income of multijurisdictional corporations attributable to activities conducted within California is subject to the California Bank and Corporation Tax. For the purpose of calculating this tax, business income is attributed to California corporate activities either by

3. CAL. REV. & TAX. CODE § 25101 (West Supp. 1987). California imposes a franchise tax based on corporate income for the privilege of doing business within the state. Id. § 23151(a). An income tax is imposed on corporations that have income from California sources but do not meet the definition of "doing business" within the state. Id. § 23501(a). Doing business is generally defined as actively engaging in any transaction for the purpose of financial or pecuniary gain. Id. § 23101 (West 1979).
4. Business income is defined as "income arising from transactions and activity in the regular course of... business." Id. § 25120(a) (West 1979). Income from tangible and intangible property is included in the definition of business income if the acquisition, management, and disposition of the property constitutes an integral part of the taxpayer's regular trade or business. Id. Nonbusiness income is not attributed to California in the same manner as business income. The statutory definition of nonbusiness income is simply "all income other than business income." Id. § 25120(d). An example of nonbusiness income would be interest earned from the investment of idle funds. See Keesling & Warren, California's Uniform Division of Income for Tax Purposes Act, 15 UCLA L. Rev. 156, 163 (1967) [hereinafter cited as Keesling & Warren, California's UDITPA I] (discussion of the nature of business income). Some forms of nonbusiness income are allocated on the basis of the commercial
means of a statutory apportionment formula\(^5\) or by a method that is commonly known as separate accounting.\(^6\) Whether the multi-jurisdictional corporate taxpayer uses apportionment\(^7\) or separate accounting to attribute business income to California depends upon the relationships between the business activities within the state and the out-of-state business activities.\(^8\) If the activities within California are an inseparable portion of a business carried on within and without the state, then the activities are considered a single "unitary" business.\(^9\) A corporate taxpayer is required to apportion the business income of a unitary business.\(^10\) In California, apportion-

\(^5\) The statutory apportionment formula assigns a fraction of the business income to California on the basis of three factors: property, payroll, and sales in California. Cal. Rev. & Tax. Code § 25128 (West 1979); see id. §§ 25129-25136 (West Supp. 1987) (statutory instructions on the application of the three factor apportionment formula; see infra notes 96-110 and accompanying text (discussion of the statutory apportionment formula).

\(^6\) Cal. Admin. Code tit. 18, § 25101(a) (Dec. 1982); Keesling & Warren, The Unitary Concept in the Allocation of Income, 12 Hastings L.J. 42, 43 (1960) [hereinafter cited as Keesling & Warren, The Unitary Concept]. The term "separate accounting" is derived from the fact that activities in the various jurisdictions are treated as separate businesses. See id. (discussing the concept of separate accounting). Separate accounting presumes that receipts and expenses can be segregated geographically. The resulting income is shown in the accounting records as "either completely connected with, or completely separable from, a given state." Boren, Separate Accounting in California and Uniformity in Apportioning Corporate Income, 18 UCLA L. Rev. 478, 486 (1971). See infra notes 56-95 and accompanying text (discussion of separate accounting).

\(^7\) The term "apportionment" is used throughout this comment to refer to the use of the statutory apportionment formula to attribute business income to California business activities. See also supra note 5 (definition of the apportionment formula).

\(^8\) See Keesling & Warren, The Unitary Concept, supra note 6, at 45-46.

\(^9\) Id. at 46. The unitary business concept is a direct descendant of the "unit rule." J. Hellerstein, State Taxation: Corporate Income and Franchise Taxes 330 (1983). The unit rule was used to determine the portion of the value of the capital stock of an interstate railroad which could be taxed by a particular state. State R.R. Tax Cases, 92 U.S. 575 (1875); see also Pittsburg C. & St. L. Ry. v. Backus, 154 U.S. 421 (1894); Delaware R.R. Tax Cases, 85 U.S. (18 Wall.) 206 (1873). Under the unit rule, the apportionment was measured by multiplying the total value of the capital stock by the ratio of the track mileage of the railroad within the state to the entire rack mileage of the railroad. State Railroad, 92 U.S. at 608. The unit rule was also used in other cases involving telegraph companies, express companies, and toll bridges. See Henderson Bridge Co. v. Kentucky, 166 U.S. 150 (1897); Adams Express Co. v. Ohio, 165 U.S. 194 (1897); Pullman Car Co. v. Pennsylvania, 141 U.S. 18 (1891); Western Union Tel. Co. v. Massachusetts, 125 U.S. 530 (1888).

\(^10\) Cal. Admin. Code tit. 18, § 25101(a) (Dec. 1982). In addition, if one multijurisdictional corporate taxpayer is engaged in a unitary business with an affiliated corporation or corporations, the business income attributable to California must be determined by applying the apportionment formula to the combined income of all affiliated corporations. See Edison Cal. Stores, Inc. v. McColgan, 30 Cal. 2d 472, 480, 183 P.2d 16, 21 (1947). Finally, affiliated corporations with wholly intrastate business activities may elect to apportion the combined business income of the corporations if the relationships between the activities of the affiliated corporations are considered unitary. Cal. Rev. & Tax. Code § 25101.15 (West Supp. 1987).
ment means that a fraction of the business income is assigned to California on the basis of property, payroll, and sales within the state. On the other hand, separate accounting is used if the activities within California are truly separate and distinct from the activities conducted outside the state. Clearly, the unitary business concept is the key to the determination of business income attributable to California and to the calculation of California income tax liability.

Activities that are vertically integrated, or are in the same line of business, fall well within the scope of the unitary business concept. Diverse corporate activities are those activities that are neither vertically integrated nor in the same line of business. When multijurisdictional corporate activities are diverse, the characterization of the activities as either unitary or nonunitary is difficult. Statutory provisions offer little in the way of practical guidelines that can be used by taxpayers and tax administrators in the characterization of diverse business activities. In addition, guidelines contained in Franchise Tax Board regulations are helpful.

11. See infra notes 96-110 and accompanying text (discussion of apportionment formula).
13. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 (1980). The Supreme Court described the unitary business concept as the “linchpin of apportionability.” Id.
14. Vertically integrated activities involve the various progressive steps of a business that are necessary to make a product available to a market. J. Hellerstein, supra note 9, at 443. See also Cal. Admin. Code tit. 18, § 25120(b)(2) (June 1973) (Franchise Tax Board definition of vertically integrated business). An example of a vertically integrated business is a business that operates a saw mill, uses the lumber to manufacture outdoor furniture, and operates the retail stores in which the furniture is sold. See Chase Brass & Copper Co. v. Franchise Tax Bd., 10 Cal. App. 3d 496, 502, 95 Cal. Rptr. 805, 808 (1970) (extraction, smelting, and refining of copper).
15. An example of the “same line of business” concept is the various activities involved in the operation of a nationwide chain of retail furniture stores. See Butler Bros. v. McColgan, 315 U.S. 501 (1942) (seven wholesale houses operated out of a central distributing center); F.W. Woolworth Co. v. New Mexico Taxation & Revenue Dep’t, 458 U.S. 354 (1982) (chain of department stores).
16. See Cal. Admin. Code tit. 18, § 25120(b) (June 1973). A taxpayer is presumptively engaged in a unitary business if the taxpayer is engaged in vertically integrated activities or activities that are in the same line of business. Id.
18. J. Hellerstein, supra note 9, at 393 (broad definitions offer “little practical guidance in deciding unitary business controversies”).
19. Id.
only when the corporate activities are vertically integrated or in the same line of business.\textsuperscript{20}

Because of the absence of any practical statutory or administrative guidelines for determining whether a diverse business is a unitary business, courts and the California State Board of Equalization employ a "factors approach" to determine the existence or nonexistence of unity among the diverse activities.\textsuperscript{21} Under the factors approach, the relationships between the activities of the corporate taxpayer are compared to factors that have been set forth in case law to show evidence of unity.\textsuperscript{22} Activities are characterized as unitary, and apportionment is required, if a sufficient number of unitary factors are present.\textsuperscript{23} In practice, the determination of whether diverse business activities constitute a unitary business requires "the examination of a multitude of potential unitary factors and the very subjective weighing of the significance of those factors."\textsuperscript{24} As an ad hoc method of solving the problem of characterizing diverse business activities, the factors approach has proven less than satisfactory because the unitary factors have never been organized into an order of importance.\textsuperscript{25} Taxpayers and tax administrators attempting to characterize the activities of a diverse business are not certain which of the factors are essential to the existence of unity, which factors are important to the existence of unity, and which factors do not evidence unity.\textsuperscript{26} Uncertainty in the characterization of diverse business activities carries all the way through the filing process to the determination of taxable income and the income tax liability.

When reporting the business income attributable to California on the corporate tax return,\textsuperscript{27} the multijurisdictional corporate

\begin{footnotes}
\footnotetext[20]{CAL. ADMIN. CODE tit. 18, § 25120(b) (June 1973) (presumption of unity if the activities are in the same line of business or constitute "steps in a vertical process").}
\footnotetext[21]{See Boren, supra note 6, at 496-509 (description and discussion of the "factors approach").}
\footnotetext[22]{Id. at 499-508 (factors present in unitary businesses).}
\footnotetext[23]{Blakenship, California's Unitary Tax System—Does It Make Sense?, 46 CAL. C.P.A. Q. 18, 19 (1978).}
\footnotetext[24]{See Boren, supra note 6, at 497-98; Seago, The Revitalization of the Unitary Business Principal—ASARCO and Woolworth, 1 J. Sr. TAX'S 101, 116 (1980). The discussion of the criteria necessary for the existence of unity has proven far more controversial than the debate over the statutory apportionment formula. Tannenwald, supra note 2, at 651.}
\footnotetext[25]{See Seago, supra note 25 at 116 (impossible to know the weight given by the court).}
\footnotetext[26]{Corporate taxpayers are required to transmit a return to the Franchise Tax Board within two months and 15 days after the close of each income year. CAL. REV. & TAX. CODE § 25401(a) (West 1979).}
\end{footnotes}
taxpayer must first characterize the corporate activities in California as either unitary or nonunitary. The taxpayer may protest additional taxes assessed by the Franchise Tax Board as a result of any contrary characterization of the corporate activities. Finally, to resolve the dispute between the taxpayer and the Franchise Tax Board, a trier of fact independently characterizes the activities as either unitary or nonunitary. To minimize the number of disputes and to resolve disputes that arise, a clear definition of the scope of the unitary business concept is needed. The factors approach has evolved as one way to define the scope of the unitary business concept.

Under the factors approach, the characterization of diverse business activities requires close scrutiny of the underlying relationships between the business activities. In the process of justifying the characterization, a court will not allow the corporate taxpayer or tax administrators to simply list relationships which are labeled "unitary." The court must be convinced, after an examination

28. Business income attributed to California must be reported as income on the tax return. See id. §§ 25101 (West Supp. 1987), 25401(a) (West 1979).


30. The Franchise Tax Board has the power to examine the tax returns of corporate taxpayers and determine the "correct" amount of the tax. Cal. Rev. & Tax. Code § 25661 (West 1979).

31. If the Franchise Tax Board determines that the tax shown on the original return is less than the tax disclosed by examination, a notice is mailed to the taxpayer disclosing the amount of the additional tax and the reason for the proposed additional tax. Id. § 25662 (West 1979). In addition, the Franchise Tax Board, upon written request, must disclose to the taxpayer the basis used to attribute income to California. Id. § 25101 (West Supp. 1987). If the taxpayer files a protest with the Franchise Tax Board, an oral hearing is conducted by the Franchise Tax Board. The taxpayer may file with the State Board of Equalization an appeal of any action by the Franchise Tax Board. Id. §§ 25666 (West Supp. 1987), 25667 (West 1979). See Walker & Smith, supra note 29, at 20-21.

32. On appeal from the Franchise Tax Board, the State Board of Equalization acts as trier of fact. See Cal. Rev. & Tax. Code § 25667 (West 1979). Upon an adverse decision from the State Board of Equalization, the taxpayer may elect to pay the tax and file a claim for refund with the Franchise Tax Board. After the denial of the claim by the Franchise Tax Board, the taxpayer may file an action in superior court to recover the refund. Cal. Rev. & Tax. Code § 26102. See id. §§ 26101-26107 (West 1979) (procedures for suit for refund). See Walker & Smith, supra note 29, at 21 (discussion of taxpayer's remedies).


of the true nature of the relationships that exist between the activities, that the activities resulted in an exchange of values that are not capable of precise measurement.

A diverse business may appear to be operated as a single business. Diversified corporations often manage the various diverse activities through a tightly controlled system of centralized management. As a result, the corporation appears to operate as a single economic unit. What is not always clear is whether the basic operations of the diverse business must be integrated to establish unity or whether strong centralized management alone is sufficient to establish unity. This comment will focus on the identification of unitary factors that evidence the integration of basic operations and the extent to which those factors are required to find the existence of unity.

This comment will examine the strengths and weaknesses of the two income determination methods, apportionment and separate accounting. A discussion of the background and general nature of the unitary business concept will follow. The judicially created tests for unity will then be discussed. Finally, this comment will discuss how the unitary factors as set forth in case law are used to define the scope of the unitary business concept as applied to the diverse business. In conclusion, this comment will suggest that a hierarchy can be established for unitary factors. In support of this conclusion, this comment will recommend an approach to testing diverse business activities for unitariness based on the hi-

35. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 440 (1980). "One must look principally at the underlying activity, not at the form of investment..." Id.
37. *See* Boren, *supra* note 6, at 517.
38. Basic operations are defined as those activities that are most essential to the earning of income. Examples of basic operations include manufacturing, producing, refining, transporting, buying, and selling. *See* Keesling & Warren, *The Unitary Concept*, *supra* note 6, at 50; J. HELLERSTEIN, *supra* note 9, at 443.
40. *See infra* notes 96-110 and accompanying text (discussion of the apportionment method).
41. *See infra* notes 56-95 and accompanying text (discussion of the separate accounting method).
42. *See infra* notes 111-32 and accompanying text (discussion of background and nature of the unitary business concept).
43. *See infra* notes 133-79 and accompanying text (discussion of judicially created tests for unity).
44. *See infra* notes 180-263 and accompanying text (discussion of the various unitary factors).
45. *See infra* notes 264-71 and accompanying text (discussion of a hierarchy of unitary factors).
erarchy of unitary factors. The hierarchy of unitary factors will be used in recommending the development of an administrative regulation defining the scope of the unitary business concept as applied to diverse businesses.46

INCOME DETERMINATION METHODS

The California Bank and Corporation Tax Law imposes a tax on corporate income.47 When a corporate taxpayer derives income from activities within and without the State of California, California income tax liability is based on the business income attributable to activities within the state.48 The method used to determine the income attributable to California depends upon the relationships between the activities conducted within and without the state.49 The Franchise Tax Board requires the use of the apportionment method if the activities conducted in California are part of a "unitary" business.50 If the activities are not unitary, the Franchise Tax Board permits the use of separate accounting.51

An important rationale for requiring the use of apportionment is that separate accounting does not adequately measure the income attributable to California from a unitary business.52 Separate accounting treats the California activities of the corporate taxpayer as a business that is entirely separate and distinct from the out-of-state activities.53 The income of the separate business that is reflected in the accounting records at the close of the income year is reported as the income attributable to the corporate activities in California.54 If, however, the activities within the state constitute an inseparable part of a multijurisdictional business, separate accounting will often inadequately reflect transfers of value that take place between the components of such a unitary business.55

46. See infra notes 272-73 and accompanying text (discussion of the need for an administrative regulation).
47. CAL. REV. & TAX. CODE §§ 23151(a), 23501 (West 1979).
48. Id. § 25101 (West Supp. 1987).
49. See Keesling & Warren, The Unitary Concept, supra note 6, at 45-48; see also Boren, supra note 6, at 481.
51. See id. § 25137 (West 1979).
52. See Keesling & Warren, California's UDITPA I, supra note 4, at 167.
53. See Boren, supra note 6, at 486.
54. See id. (income shown on the books of the corporation either completely connected with or completely separable from a given state).
In certain circumstances, separate accounting will fail to adequately measure the income attributable to California of a diverse business that is unitary.

A. Separate Accounting

The separate accounting method of attributing income to California assumes that receipts and expenses from activities of a corporate taxpayer can be segregated geographically. To determine taxable income, a taxpayer must establish and maintain a separate set of accounting records for business activities conducted within the state. Receipts and expenses are entered into the accounting records according to traditional accounting rules. Theoretically, the income reflected in the accounting records for a particular state constitutes only income from activities conducted within that state.

The records used in separate accounting are designed to record the receipts and expenses of a single type of activity as a whole, and are not designed to assign receipts and expenses to a particular jurisdiction. Consequently, a substantial number of intracompany transactions across jurisdictional boundaries may result in an inaccurate measure of the income attributable to California. Intracompany transactions present two problems for separate accounting. First, an accurate price may be difficult to establish. Second, in the process of attempting to establish a fair price for the transaction, intangible values may be overlooked.

1. Transfer Pricing: An Inaccurate Measurement for Unitary Activities

One of the major weaknesses of separate accounting is the inability to approximate fair market prices for goods and services.

56. See Boren, supra note 6, at 486.
57. J. Hellerstein, supra note 9, at 323.
58. Id. See infra note 66 (discussion of traditional accounting rules).
59. Boren, supra note 6, at 486.
60. Because the accounting records are organized geographically, each transaction is recorded as if it is wholly associated with the state. No attempt is made to divide the income between jurisdictions. See Boren, supra note 6, at 486.
61. Intracompany transactions involve exchanges of goods and services between divisions and departments of one corporation or two or more corporations that are part of an affiliated group of corporations. Comment, The Unitary Tax Method: Are the Factors Used by California in the Determination of Unity Still Viable After ASARCO and Woolworth? 15 Pac. L.J. 109, 110 (1983).
63. See infra notes 65-79 and accompanying text (discussion of transfer pricing).
64. See infra notes 80-95 and accompanying text (discussion of intangible values).
exchanged in internal transactions between activities of the same business.65 Traditional accounting rules66 require that objective information be used to record the value of transactions.67 When parties deal at arm’s length, the information gathered about the transaction is objective and is an accurate measure of the value of the transaction.68

Intracompany transactions, however, are not based on arm’s length information.69 Instead, different segments of the same company attempt to approximate fair arm’s length prices through the use of “transfer prices.”70 Separate accounting enters the transfer price as revenue in the accounting records of the seller and as an expense in the records of the buyer.71 To the extent possible, transfer prices are based on objective outside market price data.72 As the operations of the various activities become more closely related and interdependent, however, the availability of accurate market price data is diminished.73 For example, vertically integrated activities, such as a manufacturer-retailer combination, are highly interdependent.74 In vertical integration, the activities of one segment cannot be conducted without an exchange of product or services

65. J. Hellerstein, supra note 9, at 367 (the author refers to this weakness as the “Achilles heel” of separate accounting).
66. Accountants are required to follow “generally accepted accounting principles.” See Cal. Bus. & Prof. Code § 5018 (West Supp. 1987) (requiring accountants to follow the regulations of the California Board of Accountancy); Cal. Admin. Code tit. 16, §§ 5, 58.1, 2, 3 (Apr. 1983) (regulation requiring accountants to follow generally accepted accounting principles). “Generally accepted accounting principles incorporate the consensus at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting.” 3 Am. Inst. Cert. Pub. Accts., Professional Standards, Accounting § 1026.01 (July 1, 1986) (footnote omitted). These principles have no single authoritative source. They have evolved over years and through repeated use have become generally accepted. H. Sellin, Attorney’s Handbook of Accounting § 1.04[4][d] (3d ed. 1986).
67. See W. Kieso & J. Weygandt, Intermediate Accounting 38 (3d ed. 1980). The objectivity principle is a basic tenet of accounting. The accountant feels that information provided by objective and verifiable sources is more reliable. See id.
68. See id.
69. See Comment, supra note 61, at 109-10.
70. Id. A transfer price is the price charged by one segment of a business for a product or service provided to another segment of the same organization. For example, a manufacturing division will charge a retailing division a price for goods manufactured and transferred to the retailing division for sale to customers. C. Horngren, Cost Accounting: A Managerial Emphasis 634 (5th ed. 1982); J. Hellerstein, supra note 9, at 325.
71. See C. Horngren, supra note 70, at 634.
72. Id. at 634-35.
73. See id. at 636 (substitutes for market prices are not available because few markets are perfectly competitive and no intermediate markets exist for the exact product or service in question).
74. Id. at 638.
with the other segment. In addition, a market price may not be available because the product or service offered by one segment may be so unique to the taxpayer’s business that no market exists.

Without objective market price information, the transfer price must be artificially imposed on the transacting segments of the business. Although a variety of methods are available for the calculation of an appropriate transfer price, the fact remains that, as a self-reported piece of information, the transfer price is unreliable as a true measure of the value of an intracompany transaction. With self-reported transfer prices, the corporate taxpayer has the ability to adjust the transfer price in such a way as to shift income between taxing jurisdictions.

In conclusion, transfer prices may be appropriate for determining taxable income when market price information is readily available. When intracompany transactions involve highly interdependent segments of the business, however, market price data is seldom available. Because diverse businesses by definition are not highly interdependent, separate accounting will, in many circumstances, be appropriate for diverse businesses.

75. See id.
76. See id. at 636.
77. In reality, independent market price information is seldom available. The business must usually determine at what price the goods or services could have been sold in some fictional market, or construct an artificial price by adding some amount of profit to the cost of the goods or services transferred. J. Hellerstein, supra note 9, at 325. The transfer price method is essentially the method used by the Internal Revenue Service in auditing the federal income tax returns of multinational corporations. Taxpayers have argued that, under § 482 of the Internal Revenue Code, the Internal Revenue Service regularly uses fair arm’s length prices to attribute income of multinational corporate taxpayers to the United States. Id. at 367; see 26 U.S.C.A. § 482 (West 1978); see also Treas. Reg. § 1.482-1 (1968).
79. Tannenwald, supra note 2, at 649, 649-50; see J. Hellerstein, supra note 9, at 443; Cory, The Oil Companies’ Disappearing Profits; A Case for the Unitary Method, 12 TAX NOTES 1137, 1138 (1981). For example, suppose one segment of an aerospace business makes rocket engines in California and ships all of its product to an assembly plant in Florida. Assume that Florida imposes a lower corporate income tax rate than California. If a centralized management team sets the transfer price, the corporation will be tempted to set an artificially low price for the engines. As a result, the income for the California manufacturing division will be understated and the expenses of the Florida assembly division will be understated, thereby overstating the income of the assembly division. Nevertheless, proponents of the separate accounting method contend that manipulation of income under separate accounting is a myth. Essentially they argue that managers, whose performance is probably measured by profit, will insist on arm’s length prices. In addition, because of the relatively low state corporate income tax rates, corporations will not go to the trouble to manipulate income. See generally Taggert, Arm’s Length Pricing and the Unitary Method, 11 TAX NOTES 177 (1980).
2. Intangible Exchanges: The Difficulty of Measurement

The second major weakness of separate accounting as a method of calculating income attributable to California is that it fails to accurately measure the value of transfers other than goods and services.\(^8\) Thus, although a business is able to approximate a true arm's length price for goods and services, separate accounting may still fail to measure intangible values associated with the unique relationships between the various segments of the taxpayer's business.\(^8\) The use of transfer prices that are comparable to fair market prices may fail to account for the intangible value of interdependence and integration between the different types of business activities.\(^8\)

For example, when corporate activities are vertically integrated, the total profits of the corporation are significantly greater than the sum of the profits that would be earned if the individual components operated separately.\(^8\) Interdependence can result in reduced costs for selling and advertising and the reduction of other administrative overhead.\(^8\)

Intangible values may also arise when the activities are diverse in nature. For example, diverse segments of a taxpayer's business may be "complementary." Activities are complementary when the products and services of one segment create a market for the products and services of another segment of the same organization.\(^8\) In the *Appeal of Saga Corp.*,\(^8\) the State Board of Equalization found that the activities of a management company and an affiliated food service company were complementary rather than separate and distinct activities.\(^8\) The management company was primarily involved in the

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80. See Tannenwald, *supra* note 2, at 650; see also J. Hellerstein, *supra* note 9, at 327, 368. The United States Supreme Court emphasized the importance of being able to measure flows of value between the activities and not necessarily flows of goods and services. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178 (1983).
82. Tannenwald, *supra* note 2, at 650; see J. Hellerstein, *supra* note 9, at 368.
83. Tannenwald, *supra* note 2, at 650.
84. See id.
85. See C. Horngren, *supra* note 70, at 630. When activities are complementary, they contribute not only to the success of the corporation but also to the success of the other activities. *Id.*
87. *Id.*
design, development, financing, and management of off-campus student housing.\textsuperscript{88} At each dormitory, the food service company provided all food services for the residents. Every new dormitory developed by the management company created a new demand for food services.\textsuperscript{89} By using separate accounting the taxpayer failed to reflect the intangible value of the complementary relationship between the segments.\textsuperscript{90} Although the market value of the food services may have been readily available, the Board found the activities too intertwined to be labeled separate and distinct, and required the taxpayer to apportion the income of the two segments.\textsuperscript{91}

Other activities and relationships have been identified as likely to create intangible values unrecognized by separate accounting. For example, shared technical expertise creates a flow of value between activities that may not be measured by separate accounting.\textsuperscript{92} Likewise, the value of a centralized management team is often difficult to measure.\textsuperscript{93} Further, the sharing of goodwill and brand loyalty\textsuperscript{94} are transfers that separate accounting may be unable to measure.\textsuperscript{95} Without measurement of these valuable income-earning transfers, income will be misstated.

Separate accounting does not accurately attribute income to California when arm's length information is not available or when the intangible value of unique relationships between various segments of the taxpayer's business is not reflected in separate accounting records. Businesses susceptible to either of these problems should be regarded

\textsuperscript{88} Id.
\textsuperscript{89} Id. A complementary type relationship was also present in a State Board of Equalization decision where an equipment wholesaler supplied all the equipment needed in all new buildings developed by an affiliated construction company. Appeal of A. Epstein & Sons, Inc., St. Tax Cas. Rep. (CCH) \$ 400-971 (Cal. St. Bd. Equal. 1984).
\textsuperscript{90} Appeal of Saga Corp., St. Tax Cas. Rep. (CCH) \$ 400-261 (Cal. St. Bd. Equal. 1982) (the State Board of Equalization found the taxpayer's activities unitary and required apportionment).
\textsuperscript{91} Id.
\textsuperscript{93} McClure, \textit{supra} note 81, at 108. Determining the value of a centralized management team is the most controversial topic in the discussion of the unitary business concept. \textit{See infra} notes 221-43 and accompanying text (discussion of centralized executive force).
\textsuperscript{94} Brand loyalty is the preference consumers have for a particular brand name of products. E.J. McCarthy & S. Shapiro, \textsc{Basic Marketing} 339 (3d ed. 1983). For example, Honda manufactures and sells automobiles, motorcycles, lawn mowers, and generators. Although the products are very different, some consumers will prefer to buy a Honda generator over some other brand simply because Honda is a reputable manufacturer of motorcycles. \textit{See infra} notes 244-49 (discussion of common marketing scheme).
\textsuperscript{95} McClure, \textit{supra} note 81, at 110.
as "unitary" and, therefore, should use the statutory apportionment formula to attribute income to California.

B. Statutory Apportionment Formula

The use of the apportionment method is required when separate accounting fails to accurately measure the income attributable to California.\(^9\) Apportionment also prevents corporate taxpayers from manipulating taxable income for California through the use of transfer prices.\(^9\) Although the use of apportionment as an income determination method is based on the inaccuracy of separate accounting, the apportionment formula is not a precise method of measuring taxable income.\(^9\) Courts have been satisfied with an "honest effort" at a "rough approximation" of the income attributable to California.\(^9\) In upholding the constitutionality of apportionment, the United States Supreme Court recently noted the Court's long history of acceptance of apportionment as a practical method of deriving taxable income and the widespread use of apportionment among the states.\(^10\)

The elements of the apportionment formula are outlined by statute in three steps.\(^10\) In the first step, the corporate taxpayer uses the
formal accounting systems of the various segments to determine the income derived from all activities in all jurisdictions. The second step involves the calculation of a fraction representing the portion of the total income of the corporation to be apportioned to California. Finally, the total income of the corporation is multiplied by the fraction to arrive at the taxable income for California.

The corporate taxpayer uses a statutory formula in the second step of the process of apportionment. The formula is comprised of three equally weighted parts. The three parts of the formula are the ratio of sales in California to sales everywhere, the ratio of the average value of property in California to the average value of property everywhere, and the ratio of payroll in California to payroll everywhere. After a separate fraction is calculated for each part of the formula, the three fractions are added together and divided by three. This average of the three fractions, known as the apportionment factor, is then multiplied by the total business income of the corporate taxpayer.

For example, suppose the total income of Corporation X is $2.5 million. In addition, assume Corporation X does business in both California and New York. Finally, assume sales, property, and payroll for California, and for California and New York, are as follows:

<table>
<thead>
<tr>
<th></th>
<th>California</th>
<th>Total</th>
<th>Fraction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$10.0M</td>
<td>$20.0M</td>
<td>.50</td>
</tr>
<tr>
<td>Property</td>
<td>$.5M</td>
<td>$2.0M</td>
<td>.25</td>
</tr>
<tr>
<td>Payroll</td>
<td>$3.0M</td>
<td>$4.0M</td>
<td>.75</td>
</tr>
</tbody>
</table>


103. Id.
104. Id.
105. See id. (setting forth the formula).
106. Id. § 25134 (West 1979); CAL. ADMIN. CODE tit. 18, §§ 25134-25136 (1986) (administrative definition of sales).
110. Id.
The apportionment factor is equal to the sum of the fractions divided by three, or

\[
0.50 + 0.25 + 0.75 = \frac{1.50}{3} = 0.50
\]

A fraction of 50% of the total business income of Corporation X is apportioned to California. Therefore, the business income attributed to California activities is $2.5M multiplied by 50%, or $1.25M.

Although the apportionment method provides only a rough approximation of the income attributable to California, the method is widely accepted as a practical solution to the income measurement problems of multijurisdictional corporate taxpayers. The use of the apportionment method, however, is appropriate only if the California activities of the taxpayers are considered an inseparable part of a unitary business. The first stage of the income determination analysis must be the application of the unitary business concept.

THE UNITARY BUSINESS CONCEPT

The apportionment method is based on the idea that the source of business income cannot be isolated geographically.\(^1\) Therefore, all the segments of a corporate taxpayer are treated as a single income-earning unit.\(^2\) According to the United States Supreme Court, a corporate taxpayer should be treated as a single "unitary" business when, under the circumstances, separate accounting would result in manipulation or imprecise calculation of income attributable to the state.\(^3\) Before California taxable income is calculated, the unitary business concept must be applied to the various segments of the taxpayer’s business to characterize the activities of the business as

\(^{3}\) Id. at 164. See Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 438-39 (1980) (although separate accounting purports to isolate income geographically, it "may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale").
either unitary or nonunitary. The unitary business concept is central to the choice of income determination methods and to the measurement of business income attributable to California.

The unitary nature of the activities of some corporate taxpayers is readily apparent. Segments of a taxpayer that are in the same line of business typically are considered unitary because the activities are interdependent and inseparable. A chain of retail stores, for example, may rely not only upon centralized purchasing and distribution but also a common, nationally recognized name. Because these activities are so intertwined, it is difficult to attribute portions of the income from all activities to particular taxing jurisdictions.

Unity is even more apparent in vertically integrated segments that rely solely on the transfer of some product from one segment to another segment. In Chase Brass & Copper Co. v. Franchise Tax Board, the California Court of Appeal held Chase, a manufacturer of brass and copper products, to be in unity with Kennecott, an affiliated corporation. Kennecott was in the business of extracting, refining and selling copper to Chase Brass for use in the manufacture of the copper products. The activities of Kennecott were inseparably linked to the activities of Chase Brass through the transfer of the copper. Assigning all income from the ultimate sale of the copper products to Chase Brass was inappropriate because both segments contributed something to the sale. A portion of the profit had to be assigned to Kennecott, the supplier of the copper. Because of the activities of the two affiliated corporations, the court held that Chase Brass and Kennecott comprised a single unitary business and required the two corporations to apportion their combined income.


115. See Butler Bros. v. McColgan, 315 U.S. 501 (1942) (seven wholesale houses were totally dependent upon a central purchasing department and distribution center).


117. Id. at 506, 95 Cal. Rptr. at 810.

118. Id. at 501, 95 Cal. Rptr. at 807.

119. Id. at 506, 95 Cal. Rptr. at 810 (centralized policy setting also contributed to the finding of unity).

120. Each of the corporations kept a separate set of accounting records and calculated income for each corporation based on the intracompany sale of the copper. Id. at 503, 95 Cal. Rptr. at 808.


122. Chase Brass & Copper, 10 Cal. App. 3d at 506, 95 Cal. Rptr. at 810.
The interaction between the two corporations made it impossible for the court to attribute a portion of the income to California through the use of separate accounting.123

Unlike segments that are in the same line of business or are vertically integrated, the activities of diverse business are not easily characterized as unitary or nonunitary. The various segments of a diverse business ordinarily are not linked together by vital, centralized departments or transferred products.124 When diverse business activities lack these close relationships, the value of transactions between segments of the business can be accurately measured and reflected through the use of transfer prices. In addition, intangible values will not exist in the absence of close relationships between the various segments. Finally, each diverse type of activity conducted by a segment usually involves technical expertise that is unique to that segment.125 As a result, the various segments of a diverse business seldom share technical expertise.126

The fact that a corporate taxpayer is engaged in diverse business activities, however, does not preclude a finding that the activities are unitary.127 When a taxpayer is engaged in activities that are not in the same line of business and are not vertically integrated, the courts

123. Id. at 500, 95 Cal. Rptr. at 806 (Chase Brass had always used the apportionment method for its own activities within and without California, but the court's decision forced Chase to include the income and apportionment factors of Kennecott in its apportionment calculations).
126. See Appeal of Mole-Richardson Co., St. Tax Cas. Rep. (CCH) ¶ 400-652 (Cal. St. Bd. Equal. 1983). According to the State Board of Equalization, the management of the individual problems of the various diverse segments does nothing to integrate the segments into a single unitary business. Id.
and administrative agencies scrutinize unitary factors to determine whether the relationships between the segments constitute a unitary business.\textsuperscript{128} The presence of a sufficient number of these unitary factors will indicate to the court or administrative agency that the activities comprise a single unitary business even though the activities are diverse.

Recently, the State Board of Equalization reversed the finding of the Franchise Tax Board and held the activities of hotel management and fast food restaurant management to be unitary.\textsuperscript{129} In the \textit{Appeal of Atlas Hotels, Inc.},\textsuperscript{130} a parent corporation had two wholly owned subsidiary corporations. One subsidiary owned several fast food restaurants in California and the other subsidiary operated several hotels in California and Arizona. All major management decisions concerning the operations of both subsidiaries were made by a centralized management team. Further, the centralized management team had experience in both the hotel industry and the restaurant industry. Many functions such as purchasing, accounting, and legal services were centralized in the parent corporation. Finally, funds used in the restaurant operations were loaned between the hotel operations and the restaurant operations. Although the operations of the two subsidiaries were distinctly different, the Board held that there was substantial evidence of unity between the basic operations of the two companies.\textsuperscript{131} The control exercised over the operations of the subsidiaries by the central management team and the dependency of the subsidiaries upon the expertise of the central management team convinced the Board that the activities constituted a single unitary business.\textsuperscript{132}

Same line of business activities and vertically integrated activities fall well within the unitary business concept. Segments of a diverse business, however, do not exhibit the close relationships that are evident in same line of business cases and vertically integrated activities. As a result, diverse business activities are not easily characterized as unitary or nonunitary. Therefore, the process of characterizing


\textsuperscript{130} \textit{Id.}

\textsuperscript{131} \textit{Id.}

\textsuperscript{132} \textit{Id.}
diverse business activities requires a careful examination of the actual relationships that exist between various segments of a diverse business.

A. Judicial Definitions of a Unitary Business

Although established over sixty years ago, the unitary business concept remains complex and controversial. The judicial roots of the unitary business concept can be traced to the "unit rule" used in late nineteenth century decisions concerning the taxation of railroads and telegraph companies. Courts began to apply the doctrine to the taxation of income from interstate business activities in the 1920s. Despite the long history of the concept, a unitary business is still not clearly defined.

Recently, the United States Supreme Court refused to adopt a bright line test for unity. Indeed, a precise definition may be impossible to create considering the large variety of business combinations that exist. Some general guidelines are needed, however, to determine whether the activities of the various diverse business segments constitute inseparable parts of a larger business. Both California courts and the United States Supreme Court have developed generalized tests for unity.

1. California Definitions of a Unitary Business

California traditionally has used two tests to determine whether business activities are unitary or nonunitary. These tests are known as the "three unities test" and the "contribution and dependency test."
Business activities can be characterized as unitary if either of the two tests are met.

a. **The Three Unities Test**

According to the California Supreme Court in *Butler Brothers v. McCollgan*, when the segments of a corporation are linked together by unity of "ownership," unity of "operation," and unity of "use," the activities are characterized as unitary. Unity of ownership is present if the corporate taxpayer obtains sufficient percentage of ownership of the activities of the business. Unity of operation is evidenced by the existence of centralized departments such as purchasing, accounting, and legal services. Unity of use exists when the business uses a centralized management team and a common system of operation. The business activities will be characterized as unitary only when all three unities are present.

Commentators have criticized the ambiguity of the three unities test. The California Court of Appeal has noted that the terms "operations" and "use" are not clearly distinguishable. As stated by one author, the terms are "clumsy" and should not be...
used.\textsuperscript{150} Despite the confusion regarding the terms, the three unities test is still widely used in California as a test for unity.\textsuperscript{151}

\textbf{b. The Contribution and Dependency Test}

The "contribution and dependency test" for unity emerged in \textit{Edison California Stores, Inc. v. McColgan}\textsuperscript{152} and is the only test for unity that has been adopted by the Franchise Tax Board as a regulation.\textsuperscript{153} Under the contribution and dependency test, the activities of the corporate taxpayer within California are examined to determine the extent the activities "contribute to" or "depend upon" the corporate activities outside California.\textsuperscript{154} Because the contribution and dependency test is so general, application of the test is rather subjective.\textsuperscript{155}

Contribution and dependency are more common in same line of business activities and vertically integrated activities. Same line of business activities usually depend upon centralized services such as central purchasing departments and distribution centers.\textsuperscript{156} Vertically integrated activities depend upon or contribute to a flow of products from one segment of the business to another.\textsuperscript{157} These connections simplify the application of the contribution and dependency test for

\begin{itemize}
\item \textsuperscript{150} J. Hellerstein, \textit{supra} note 9, at 401.
\item \textsuperscript{152} 30 Cal. 2d 472, 183 P.2d 16 (1947).
\item \textsuperscript{153} CAL. ADMIN. CODE tit. 18, § 25120(b) (Feb. 1987) provides in pertinent part:
  The determination of whether the activities of the taxpayer constitute a single trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, \textit{dependent upon or contribute to} each other and the operations of the taxpayer as a whole.
  \textit{Id.} (emphasis added).
\item \textsuperscript{154} Edison Cal. Stores, Inc. v. McColgan, 30 Cal. 2d 472, 481, 183 P.2d 16, 21 (1947).
\item \textsuperscript{155} Mohan, \textit{supra} note 97, at 57-58, 62-63 (judges must depend upon their subjective judgment in examining the facts of each case).
\item \textsuperscript{156} \textit{See, e.g.}, Butler Bros. v. McColgan, 17 Cal. 2d 664, 111 P.2d 334 (1941), \textit{aff'd}, 315 U.S. 501 (1942) (seven wholesale houses depended upon a central purchasing department and distribution center).
\item \textsuperscript{157} \textit{See, e.g.}, Chase Brass & Copper Co. v. Franchise Tax Bd., 10 Cal. App. 3d 496, 95 Cal. Rptr. 805 (1970) (copper smelting and finishing segments of the business depended upon purchases of unrefined copper from company owned mines).
\end{itemize}
same line of business activities and vertically integrated activities.\textsuperscript{158}

Contribution and dependency between the segments of a diverse business is more difficult to find.\textsuperscript{159} Typically, the diverse activities of one segment are independent of the activities of the other segments of the business.\textsuperscript{160} The relationships between the segments of a diverse business must be carefully examined to determine whether the activities are truly separate and distinct or whether the various segments are part of a larger business.\textsuperscript{161} Unfortunately, because of the subjective nature of the test, the contribution and dependency test offers few practical guidelines for the characterization of activities as either unitary or nonunitary.\textsuperscript{162}

\textbf{2. United States Supreme Court Definitions of a Unitary Business}

The United States Supreme Court began setting the limits of the unitary business concept with \textit{Mobil Oil Corp. v. Commissioner of Taxes}.\textsuperscript{163} In decisions that have followed, the Court has used neither the three unities test nor the contribution and dependency test.\textsuperscript{164} Instead, the Court has held that the existence of unity is evidenced by functionally integrated activities,\textsuperscript{165} economies of scale,\textsuperscript{166} and

\begin{itemize}
  \item \textsuperscript{158} Appeal of Berry Enters., St. Tax Cas. Rep. (CCH) ¶ 401-267 (Cal. St. Bd. Equal. 1986) ("benefits to the [unitary] group from certain basic connections are usually readily apparent").
  \item \textsuperscript{159} See id.
  \item \textsuperscript{162} J. HELLERSTEIN, \textit{supra} note 9, at 394. At least two authors feel that the contribution and dependency test is an improvement over the three unities test. Keesling & Warren, \textit{The Unitary Concept}, \textit{supra} note 6, at 48.
  \item \textsuperscript{163} 445 U.S. 425 (1980) (Mobil engaged in exploration, production, refining and manufacturing, transportation and distribution, and sale of petroleum and petroleum products).
  \item \textsuperscript{164} See generally Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982); Exxon Corp. v. Department of Revenue, 447 U.S. 207 (1980). By failing to mention either test, the Court may have indicated a rejection of the tests. J. HELLERSTEIN, \textit{supra} note 9, at 427.
  \item \textsuperscript{165} See infra notes 174-79 and accompanying text (definition of functional integration).
  \item \textsuperscript{166} Mobil, 445 U.S. at 438 (citing Butler Bros. v. McColgan, 315 U.S. 501, 508-09 (1942)). In Butler Bros., volume purchases by a centralized purchasing department resulted in lower
\end{itemize}
centralized management. Another dimension was added to the test in Container Corp. of America v. Franchise Tax Board. According to the Court, a "flow of value" between the activities of the business is required for a constitutional finding of unity.

The power of the Supreme Court to formulate a definition of the unitary business concept stems from constitutional challenges to apportionment. Under the due process clause and the commerce clause, the Court has held that apportionment as an income determination method is not permitted unless the activities conducted within the state are part of a unitary business. Therefore, in judging the constitutionality of state tax apportionments, the Court considers the unitary business concept as the "linchpin of apportionability." The existence of "functional integration" is one of the standards used by the Court to find unity. A business is functionally integrated when interaction between the income-earning activities of the business is coordinated by a centralized management team. In Exxon Corp. v. Wisconsin Department of Revenue, the "functional prices than would have been acquired by the separate wholesale houses. The lower prices resulted in cost savings and higher profits that were not specifically identifiable with any particular wholesale house. Butler Bros., 315 U.S. at 508.


169. The rather vague concept of "flow of value" was not defined by the Court. The Court, however, is apparently focusing on a flow between segments of such intangibles as sharing of technical expertise. See Mohan, supra note 97, at 63.

170. Container, 463 U.S. at 178. Because the flow test is so imprecise, its practical usefulness in finding the existence of unity is very limited. Mohan, supra note 97, at 63.


172. See Container, 463 U.S. at 165-66; ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 316 (1982); F.W. Woolworth, 458 U.S. at 371; Mobil, 445 U.S. at 441-42. States are prohibited from taxing the income generated in interstate commerce unless (1) some minimal connection can be found between the activities of the taxpayer and the state, and (2) the income attributed to the state bears a rational relationship to the activities conducted in the state by the taxpayer. See Comment, supra note 61, at 125-37 (discussion of the constitutionality of the unitary business concept). Applying the unitary business concept to find whether or not the activities of the taxpayer within and without the state are connected through unity satisfies the first element of the United States Supreme Court test.


175. 447 U.S. 207 (1980).
departments" were operated as independent businesses. Despite the independence of the functional departments, the Court found that all the departments benefitted from "an umbrella of centralized management and controlled interaction." Under this umbrella, the Court held that the various departments formed a single unitary business.

**B. The Factors Approach to the Unitary Business Concept**

The process of characterizing diverse business activities as either unitary or nonunitary requires a clear definition of the unitary business concept. Unfortunately, current judicial definitions describe the essence of the unitary business concept but do not provide corporate taxpayers and tax administrators with clear guidelines for determining the character of business activities. The California tests and the United States Supreme Court tests merely label the types of relationships which must exist between the activities of the different segments. The tests do not facilitate a precise answer once specific relationships are identified. In other words, the taxpayer or tax administrator may apply the judicial definitions and still not know whether the segments form a unitary or nonunitary business.

An examination of those factors present in a business held to be unitary or nonunitary is a practical approach to the problem of characterizing business activities. Under the factors approach, specific relationships between segments of the taxpayer are compared to unitary factors from prior cases. A court determines whether a unitary business exists and requires apportionment if the comparisons

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176. In *Exxon*, the "functional departments" were: Exploration and Production, Refining, Marketing, Marine, Coal Shale Oil, Minerals, and Land Management. *Id.* at 212.
177. *Id.* Each functional department was operated as a separate investment center and a profit was determined for each department. A separate management team was responsible for each department. *Id.*
178. *Id.* Cf. F.W. Woolworth Co. v. New Mexico Taxation & Revenue Dep't, 458 U.S. 354, 365-66 (1982). No phase of the subsidiaries' operations was integrated with the operations of the parent corporation. "Each subsidiary functions autonomously and independently of the parent." *Id.* at 365.
180. See Boren, *supra* note 6, at 496 (the judicial tests of *Butler Bros.* and *Edison* "have proven inadequate"); J. Hellerstein, *supra* note 9, at 393 (generalized definitions offer little practical guidance).
181. *See Boren, supra* note 6, at 495.
182. *Id.*
183. *Id.*
184. *Id.* at 495-509 (an analysis of unitary factors found in both court cases and State Board of Equalization decisions).
and distinctions convince the court that the business operates as a single integrated economic enterprise.\textsuperscript{185}

Although many factors show some connection between the various segments of a business, not all of these factors will point to connections that show unity.\textsuperscript{186} An effective application of the factors approach requires more than simply indentifying the presence of some unitary factors. The application of the test requires the assign-ment of importance to specific unitary factors.\textsuperscript{187} Since an important rationale for apportionment is that separate accounting inaccurately measures the income of a unitary business,\textsuperscript{188} factors showing inter-relationships through which income could be manipulated or imprecisely measured should be given more weight than factors that simply show that the segments are related by ownership.

Only one judicial decision has discussed diverse business activities.\textsuperscript{189} Nevertheless, judicial analysis of unitary factors when the segments of the business are either in the same line of business or vertically integrated are helpful in the application of the factors to diverse businesses.\textsuperscript{190} Several administrative decisions of the California State Board of Equalization discuss the application of the unitary business concept to diverse business activities.\textsuperscript{191} Unitary factors that have

been identified and discussed in the cases can be divided into three basic categories: centralized nonoperating functions,\(^{192}\) centralized operating functions,\(^{193}\) and highly interdependent functions.\(^{194}\)

1. **Centralized Nonoperating Functions**

   a. **Common Employee Benefits**

   Corporate taxpayers frequently develop employee benefit plans that cover all employees in all segments of the corporation, even when the activities of the segments are diverse.\(^{195}\) Undoubtedly, purchase of one large benefit plan for all employees rather than several smaller plans results in a cost savings to the business as a whole. The common plan may even encourage the movement of personnel between the various segments of the business.\(^{196}\)

   Generally, common employee benefit plans do not show unity for several reasons. First, the value of the plan can be measured precisely.\(^{197}\) For example, the employer must purchase an employee health plan from an outside party. Therefore, objective outside information is available for use by accountants to allocate the cost of these plans to the various jurisdictions in which the activities are conducted.\(^{198}\) Second, the mere fact that each employee in every diverse business activity has access to the same benefits does not give rise to an unmeasureable flow of value between the diverse activities.

\(^{192}\) Nonoperating functions are activities that interact with, but are not income-earning activities. Examples of nonoperating functions include accounting, purchasing, legal services, and shipping. See infra notes 195-206 and accompanying text (discussion of centralized nonoperating functions).

\(^{193}\) Operating functions directly interact with income-earning activities. Examples of operating functions include intracompany financing, central purchasing, advertising, warehousing, shipping, and a central executive force. See infra notes 207-43 and accompanying text (discussion of centralized operating functions).

\(^{194}\) Highly interdependent functions involve income-earning activities. Examples include shared expertise, common marketing schemes, and intracompany product flow. See infra notes 244-63 and accompanying text (discussion of highly interdependent functions).


\(^{196}\) The interchange of personnel was mentioned by the Court in *F.W. Woolworth* as evidence of unity. *F.W. Woolworth* Co. v. New Mexico Taxation & Revenue Dep't, 458 U.S. 354, 371 (1982).

\(^{197}\) See J. HELLERSTEIN, *supra* note 9, at 441 (spreading the cost of centralized operations and services through the use of standard cost accounting methods).

\(^{198}\) See id.
of the business.¹⁹⁹ Common employee benefit plans, therefore, do not reveal circumstances that will result in manipulation or imprecise measurement of income.

b. Centralized Nonoperating Services

Many corporations centralize certain basic services that are required by all segments of the business.²⁰⁰ A major reason for centralization of departments such as accounting, purchasing, legal services, and marketing is to realize economies of scale or to facilitate fiscal control.²⁰¹ Centralized nonoperating services are more directly related to the operations of the corporate taxpayer than common employee benefits indicating the possibility of interrelationships that result in functional integration. In addition, under California’s three unities test, centralized nonoperating services indicate unity.²⁰² Nevertheless, centralized nonoperating services alone do not objectively reveal unity. Centralized nonoperating services are routine functions necessary to every business.²⁰³ As a result, no unmeasurable intangible value can be assigned to the use of these centralized departments.

The cost of the services provided by the nonoperating departments is not substantial in relation to the total costs of the operating activities.²⁰⁴ The lack of quantitative significance of the cost of nonoperating services, whether centralized or not, reduces the value of common nonoperating services as a unitary factor.²⁰⁵ Finally, the cost of centralized services can be easily allocated to the various segments through the use of standard cost accounting techniques.²⁰⁶ The existence of centralized services, therefore, does not give rise to

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¹⁹⁹. See id.
²⁰⁰. See id. at 440-41.
²⁰¹. Id. Irrespective of uniformity of accounting procedures, centralization of budgeting procedures, and common use of auditors and legal services, the State Board of Equalization concluded that the segments of the corporate taxpayer were not unitary. The restriction on financial activities and the fiscal reporting requirements led the Board to conclude that the parent corporation was merely overseeing the subsidiary corporation as an investment. See Appeal of Hollywood Film Enters., St. Tax Cas. Rep. (CCH) ¶ 400-169 (Cal. St. Bd. Equal. 1982).
²⁰². Under the three unities test, centralized services are considered evidence of unity of operation. Butler Bros. v. McColgan, 315 U.S. 301, 308 (1942); Chase Brass & Copper Co. v. Franchise Tax Bd., 10 Cal. App. 3d 496, 502-03, 95 Cal. Rptr. 805, 808-09 (1970).
²⁰³. J. Hellerstein, supra note 9, at 440-41.
²⁰⁴. See Boren, supra note 6, at 526-27 (connections can be measured in terms of (1) importance to the operations and (2) how much money they involve).
²⁰⁵. Id.
²⁰⁶. See J. Hellerstein, supra note 9, at 441.
circumstances that will result in manipulation or imprecise measurement of income.

2. **Centralized Operating Functions**

   a. **Intracompany Financing**

   Intracompany financing, the injection of funds by one segment into the activities of another segment, has been considered substantial evidence of unity.\(^ {207} \) Injection of capital into a particular segment has a direct impact on the income-earning activities of that segment.\(^ {203} \) Irrespective of the impact on the earnings of the segment receiving the funds, the ultimate question in determining unity is whether the intracompany financing results in some substantial *mutual* advantage to both segments of the business.\(^ {209} \)

   Under normal circumstances, the provision of funds from one diverse segment to another segment does not result in an unmeasureable flow of value between segments.\(^ {210} \) If the segment lending the funds simply acts as a commercial lending institution, no unique value is attached to the financing transaction between segments.\(^ {211} \) Further, the value of the transaction can be established easily through the use of market rates of interest on similar loans that are available from commercial lending institutions.

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\(^{209}\) See Appeal of C.H. Stuart, Inc., St. Tax Cas. Rep. (CCH) ¶ 400-977 (Cal. St. Bd. Equal. 1984). The State Board of Equalization held that if any intracompany financing was sufficient to create unity, then virtually all corporate taxpayers would be unitary. *Id.*


\(^{211}\) See Appeal of C.H. Stuart, Inc., St. Tax Cas. Rep. (CCH) ¶ 400-977 (Cal. St. Bd. Equal. 1984). *But see* Chase Brass & Copper, 10 Cal. App. 3d at 503, 95 Cal. Rptr. at 808 (unity found despite the fact that the segment could have borrowed from a lending institution).
In the *Appeal of Wynn Oil Co.*,\(^{212}\) for example, intracompany financing was considered by the State Board of Equalization to be significant evidence of unity.\(^{213}\) In *Wynn*, a parent corporation arranged all start-up financing for a fledgling subsidiary and used the assets of the parent to guarantee loans that would not otherwise have been provided to the subsidiary.\(^{214}\) A unique value was attached to the ready source of financing that was available to the subsidiary.\(^{215}\) Because the unique value of the financing arrangement was subject to imprecise measurement, the State Board of Equalization held that the activities were unitary and that apportionment was necessary to determine California's portion of the income from the taxpayer's activities.\(^{216}\) Therefore, while intracompany financing alone is not considered sufficient to show unity, if unique financing services are provided to one segment by another segment of the taxpayer's diverse business, the diverse segments may be considered unitary.

**b. Centralized Purchasing, Advertising, Warehousing, and Shipping**

The centralization of service functions such as purchasing, advertising, warehousing, and shipping usually results in a substantial savings to the corporate taxpayer as a whole.\(^{217}\) Nevertheless, these economies of scale may not result in substantial *mutual* advantage to the various diverse activities of the business.\(^{218}\) The cost of providing these functions can easily be allocated to the various segments of the diverse business using standard cost accounting methods.\(^{219}\) Some or all of the centralized functions, however, may be highly related to the basic operations of the diverse corporate taxpayer. For example, if the warehousing, advertising, and shipping functions are


\(^{213}\) Id.

\(^{214}\) Id.

\(^{215}\) Id.

\(^{216}\) See id.

\(^{217}\) In *Butler Bros.*, the United States Supreme Court held that the savings realized from centralized purchasing alone created unity between the activities. Butler Bros. v. McColgan, 315 U.S. 501, 508 (1942).


\(^{219}\) Id. "The costs of such centralized operations can be spread by cost accounting methods regularly used by accountants for internal accounting, SEC registration statements, reports to regulatory agencies for rate-making, and for other purposes." J. Hellerstein, *supra* note 9, at 441.
related to a common marketing scheme, an intangible value may be attached to the efficiency of a common marketing channel and the name recognition provided by a common advertising campaign.\textsuperscript{220} The unique value of name recognition and marketing efficiency will not be captured by separate accounting. Therefore, if the centralization of the operating services results in some unique arrangement, unity will result.

c. Centralized Executive Force

The most unsettled issue in the discussion of diverse businesses and the unitary business concept is the importance of centralized management as a factor of unity.\textsuperscript{221} A centralized executive force, such as a common board of directors or a central management committee, has been held to be a factor of "great importance" in determining the existence of unity.\textsuperscript{222} The existence of centralized management is also one of the three elements of the test used by the United States Supreme Court to determine unity.\textsuperscript{223} Nevertheless, centralized management indicates unity only if the activities of the central executive force constitute more than merely overseeing the operations of the various segments.\textsuperscript{224}

The various segments of a diverse business are, by definition, not highly integrated. Typically, because the activities of each segment are separate and distinct, the centralized executive force is not in-


\textsuperscript{221} The issues surrounding the relative importance of strong centralized management were debated at a 1986 public hearing conducted by the Franchise Tax Board on the withdrawal of Franchise Tax Board Regulation 25120(b)(3) recognizing strong centralized management as an indicia of unity. Transcript of Hearing on Regulation 25120 before Franchise Tax Board (Sept. 30, 1986) (copy on file at the \textit{Pacific Law Journal}).


\textsuperscript{223} Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 438 (1980). The other two elements are functional integration and economies of scale. \textit{Id}.

volved in coordinating interaction between segments. If the operations of the segments are truly unrelated, then the function of the central management group is to oversee each segment as if that segment were a separate business. The various segments experience no mutual benefit because the task of overseeing one distinct segment does not affect relationships with any of the other segments of the business. The use of separate accounting is appropriate because the cost of overseeing the operations can be allocated to each segment by means of standard cost accounting techniques.

Coordination of interaction between various segments of the business involves more than merely overseeing the operations of the various segments. Courts have found unity when the segments of a business were highly integrated and the basic operating functions of the various segments were coordinated under an "umbrella of centralized management." Unity is evident when the segments mutually benefit from the centralized coordination of activities. In a highly integrated business, centralized management can create unity even if the centralized management group is not involved in the day-to-day management of the affairs of each segment. Setting major policy in the coordination of integrated activities not only affects all segments individually but also affects the relationships between segments. Separate accounting is incapable of adequately measuring the value of the mutual benefit gained from the overall coordination of the relationships between segments. Centrally coordinated inter-

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226. Id. (viewed as a "group of unrelated investments").
227. Id. (viewed as a "group of unrelated investments").
228. See supra note 219 (discussion of taxpayer's ability to use standard cost accounting techniques to allocate centralized services).
229. Exxon Corp. v. Department of Revenue, 447 U.S. 207, 224 (1980). Exxon was a "highly integrated business" which benefited from an "umbrella of centralized management and controlled interaction." Id.
230. See id.
231. Mohan, supra note 97, at 61 ("[i]f the same managers are making the major policy decisions for each business in the affiliated group, it is extremely difficult to argue against the finding of a unitary business").
233. See Exxon Corp. v. Department of Revenue, 447 U.S. 207, 225 (1980) (separate accounting not adequate when there was an "umbrella of centralized management").
action between different segments of the business is indicative of a single unitary business.\textsuperscript{234}

When diverse activities are coordinated to complement each other, mutual benefit may result from an umbrella-like coordination of the complementary activities. A unique value can be attached to the activities of the central management team that cannot be measured by separate accounting techniques. In \textit{Appeal of A. Epstein \& Sons, Inc.},\textsuperscript{235} the taxpayer was engaged in three distinct activities: architectural design, construction of commercial office buildings, and wholesale distribution of office equipment.\textsuperscript{236} Despite the fact that these functions ordinarily are unrelated, the State Board of Equalization held that the taxpayer was a unitary business.\textsuperscript{237} The activities in \textit{Epstein} were found to be unitary because the equipment wholesaler supplied each newly constructed office building with all of the needed equipment. The activities of the central management team involved coordinating the income-earning activities of both segments of the business. A unique value was associated with the recognizable corporate package being marketed to the public. Accordingly, the taxpayer was required to apportion the combined income of all three segments.\textsuperscript{238}

The most controversial aspect of centralized management in a diverse business involves a diverse business with strong centralized management control over totally unrelated segments.\textsuperscript{239} Taxpayers argue that unity is present when the central management group is highly involved in all aspects of the day-to-day operation of each unrelated segment of the business.\textsuperscript{240} These taxpayers feel that, essentially, the segments are operated as a single business and that an unmeasureable intangible value is associated with this type of control.

At this writing, the Franchise Tax Board has proposed the repeal of a regulation recognizing that strong centralized management of unrelated segments is an indicia of a unitary business.\textsuperscript{241} The position

\begin{footnotesize}
\begin{itemize}
    \item 234. \textit{Id.}
    \item 235. \textit{St. Tax Cas. Rep. (CCH) \textsuperscript{\textdagger} 400-971 (Cal. St. Bd. Equal. 1984).}
    \item 236. \textit{Id.}
    \item 237. \textit{Id.}
    \item 238. \textit{Id.}
    \item 239. \textit{See, e.g., Appeal of J.B. Torrance, Inc., St. Tax Cas. Rep. (CCH) \textsuperscript{\textdagger} 401-071 (Cal. St. Bd. Equal. 1985) (operating a mobilehome park completely unrelated to operating a cattle ranch).}
    \item 240. \textit{Id.} (the sole proprietor made most of the important day-to-day decisions in operating the mobilehome park in California and the cattle ranch in Oregon).
\end{itemize}
\end{footnotesize}
of the Franchise Tax Board is that no unique value can be shown by the day-to-day management of various distinct segments of a business. Because no unique value exists, separate accounting can adequately account for the cost of the central management group and apportionment is unnecessary.

3. Highly Interdependent Functions

a. Common Marketing Scheme

A common marketing scheme typically distributes products through a common marketing channel under a common name and logo. Even if a diverse group of products is independently produced by various segments of the business, the distribution will be coordinated to take advantage of name recognition and brand loyalty. The value of shared name recognition and shared marketing is difficult to quantify. Apportionment is necessary because separate accounting is unable to adequately measure these values.

In *Appeal of Lancaster Colony Corp.*, the taxpayer had a number of segments that independently produced a large variety of consumer goods. Many of the products were marketed under the name of Lancaster Colony. In addition, the parent corporation provided assistance in package design and market distribution. In holding the taxpayer to be unitary, the State Board of Equalization found that the marketing services provided by the parent corporation had a unique value that was incapable of adequate measurement by separate accounting.

b. Flow of Expertise

Separate accounting is unable to accurately measure the benefit associated with several segments of a diverse business sharing a

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242. Id.
243. Id.
245. Id.
246. See id. (coordination of products through common marketing channels created high degree of interdependency).
247. Id.
248. Id.
249. See id.
common pool of technical expertise.\textsuperscript{250} Intangible values associated with the mutual dependency of several segments on a common pool of expertise are likely to go unnoticed in a separate accounting system and apportionment is better suited as a method for attributing income to California.\textsuperscript{251} Even diverse business activities may draw technical assistance from a common pool of expertise. For example, in the \textit{Appeal of Powerine Oil Co.},\textsuperscript{252} an oil company entered into a joint venture to mine copper. Although the refining of oil was a significantly different process than the mining of copper, the State Board of Equalization characterized the activities as unitary. The Board found that the joint venture relied on the expertise of the oil company regarding geological structure and techniques for exploration and extraction of resources.\textsuperscript{253} The transfer of vital information from one segment to the other was incapable of adequate measurement by separate accounting and apportionment was required.\textsuperscript{254}

c. Intracompany Product Flow

According to the United States Supreme Court, intracompany product flow is not required to show unity.\textsuperscript{255} Nevertheless, with the exception of one decision,\textsuperscript{256} when the activities of the business have involved a significant exchange of goods or services, unity has always been found.\textsuperscript{257} Separate accounting usually is unable to capture the

\textsuperscript{250} See Exxon Corp. v. Department of Revenue, 447 U.S. 205, 225 (1980) (a centralized management department assisted segments in technical matters).


\textsuperscript{253} Id.

\textsuperscript{254} See \textit{id}.

\textsuperscript{255} \textit{Container Corp. of America v. Franchise Tax Bd.}, 463 U.S. 159, 178 (1983).

\textsuperscript{256} \textit{Arkla Indus., Inc. v. Franchise Tax Bd.}, 188 Cal. App. 3d 530, 233 Cal. Rptr. 495 (1986) (certified for depublication on April 16, 1987; petition for reconsideration denied on May 13, 1982).

value of the interdependence involved in the exchange of the goods and services.258

Product flow between diverse segments is not common.259 A flow of goods and services may, however, be merged together in a common marketing scheme.260 Although goods and services are not exchanged directly between diverse segments of the same business, they are presented to the consuming public as a single commodity. The value of this type of "complementary"261 relationship is unique and likely unmeasureable by separate accounting. For example, in the Appeal of Lancaster Colony Corp.,262 a total of seven divisions and fourteen subsidiaries manufactured and sold a variety of consumer goods through a coordinated marketing program. This flow of goods from the diverse segments of the business through a central channel created unity between the segments and permitted the use of apportionment.263

**HEIRARCHY OF UNITARY FACTORS**

In the characterization of activities as unitary or nonunitary, no single factor controls the final determination of unitariness.264 As a general rule, the more factors indicating unity, the more likely unity will be found. Although some factors have been regarded as more important than others in showing the existence of unity, the precise weight given to the factors is unknown.265 Nevertheless, a heirarchy of unitary factors can and should be developed to aid corporate taxpayers and tax administators in the characterization of activities as unitary or nonunitary.

The unitary factors should be organized into three tiers of importance. The least important factors are the centralized nonoperating functions. The State Board of Equalization has viewed common employee benefit plans and centralized nonoperating departments as

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258. Tannenwald, supra note 2, at 650.
259. As opposed to product flow being common in and necessary to vertically integrated or same line of business activities. See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178 (1983).
260. See supra notes 244-46 and accompanying text (discussion of common marketing scheme).
261. See supra note 85 and accompanying text (definition of complementary).
263. Id.
265. See Boren, supra note 6, at 525-29.
simply "housekeeping" functions that alone can never show unity.\textsuperscript{266} These types of functions will often exist no matter how unrelated the activities may be.\textsuperscript{267} Because no unique unmeasurable value can be indentified, separate accounting can easily allocate the cost of these "housekeeping" functions to individual segments.

The next tier is comprised of the centralized operating functions. Functions such as intracompany financing, centralized purchasing, advertising, warehousing, shipping, and centralized management, individually, will seldom show unity.\textsuperscript{268} A careful analysis of the underlying activities, however, may reveal circumstances in which unity might exist. For example, if centralized operating functions such as purchasing, warehousing, shipping, and advertising are part of a common marketing scheme, sufficient interdependence will exist to characterize the activities as unitary.\textsuperscript{269}

The most important factors are the "highly interdependent functions."\textsuperscript{270} Functional unitary factors such as shared technical knowledge, common marketing schemes, and intracompany product flow, alone can be sufficient to show unity.\textsuperscript{271} Highly interdependent functions involve unique relationships between segments of a business with intangible values that are unmeasureable by separate accounting.


\textsuperscript{270} See infra notes 244-63 and accompanying text (discussion of highly interdependent functions).

These unique relationships reveal the existence of a single unitary business because separate accounting is incapable of measuring their intangible value.

THE NEED FOR AN ADMINISTRATIVE REGULATION

Corporate taxpayers and tax administrators need clearer guidelines for characterizing corporate activities as unitary or nonunitary. The California Franchise Tax Board has the authority to enact administrative regulations providing guidelines to aid in the determination of the corporate tax liability. The Franchise Tax Board is currently proposing to withdraw an administrative regulation permitting the finding of unity between segments of a diverse business when evidence of strong centralized management is present. After the withdrawal of this regulation, corporate taxpayers will have no administrative guidelines by which diverse business activities may be characterized. This comment proposes the adoption by the Franchise Tax Board of an administrative regulation that contains guidelines for characterizing a business as unitary or nonunitary.

The regulation should include the description of a general test for unity. The general test developed by the United States Supreme Court should be used in the regulation. This test should be used because the Court has apparently rejected other tests for unity by refraining from adopting any other existing test for unity. Adoption of the test used by the Supreme Court would require the existence of functional integration as well as centralized management and economies of scale.

In addition, the regulation should identify specific unitary factors and arrange the factors in a hierarchy of importance. Finally, to prevent the establishment of an inflexible bright line test, presumptive language should be used to create a rebuttable presumption of unity if certain factors are present. With regulatory guidelines, disputes between taxpayers and tax administrators will be reduced. Both parties can proceed with greater confidence in the characterization of diverse business activities as either unitary or nonunitary.

CONCLUSION

When business activities within the state are an inseparable part of a single "unitary" business conducted both within and without

the state, a multijurisdictional corporate taxpayer must use a special 
apportionment formula to attribute business income to California. 
Under the separate accounting method of attributing business income 
to California, the income of a unitary business is subject to manip-
ulation and imprecise measurement. Therefore, the apportionment 
method is used. An understanding of the concept of the unitary 
business is essential to the process of attributing the income of 
multijurisdictional corporate taxpayers to California.

Although diverse business activities ordinarily do not form a single 
unitary business, they may be coordinated so as to create unity. The 
coordination or "functional integration" of the activities creates unity 
in the activities despite the fact that the basic operations are unrelated.
Nevertheless, taxpayers and tax administrators are uncertain as to 
the degree of coordination necessary to create unity in the diverse 
decision and require the use of apportionment to attribute business 
income to California.

Uncertainty would be substantially reduced through the establish-
ment of a heirarchy of unitary factors. Factors that show the existence 
of an exchange of unique products or services, or show the ability 
of the taxpayer to manipulate taxable income, must be characterized 
as unitary factors. A few factors will show strong evidence of the 
existence of unity. Other factors will show unity only in unusual 
situations. Some factors can never show unity. The controversy over 
the characterization of diverse business activities as unitary or non-
unitary can be substantially reduced if these factors are identified by 
the Franchise Tax Board in an administrative regulation and arranged 
in a heirarchy of importance as proposed by this comment.

L. Steven Spears