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## **3000      UNITY**

R&TC §25101 provides that when the income of a taxpayer is attributable to sources both within and without California, the taxpayer is required to measure its franchise tax liability by its income attributable to sources within the state. The portion of the total income that is considered to be attributable to California is determined in accordance with unitary business principles.

Under the unitary method, all of the activities comprising a single trade or business are viewed as a single unit, irrespective of whether those activities are conducted by divisions of a single corporation or by commonly owned or controlled corporations. (*Edison California Stores v. McColgan* (1947) 30 Cal.2d 472.) The business income from all of the unitary business activities is combined into a single report (the combined report). An apportionment formula is then applied to the combined business income to determine the portion attributable to California.

Although R&TC §25101 provides the general authority for use of the unitary method, the application of this concept has not been defined by statute. Instead, the law has evolved through a series of judicial decisions. California's reliance upon a "source" basis of taxation is consistent with both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the United States Constitution. Refer to MATM 1100 for a detailed discussion of the Due Process Clause and Commerce Clause.

This section of the manual will discuss the development and application of the unitary concept and some of the key court and SBE decisions that have helped to shape the current interpretation of a unitary business. The following sections (beginning with MATM 3500) will focus on specific audit steps and techniques for performing a unitary audit.

## **3005      DEVELOPMENT OF THE UNITARY CONCEPT**

The theory underlying the unitary business principle has its roots in real property tax law, where it arose in the context of railroad taxation. In *Union Pacific Railway Co. v. Ryan* ((1884) 113 U.S. 516, 28 L.Ed. 1098, 5 S.Ct. 601), the U.S. Supreme Court recognized that the value of a railroad could not be measured merely by looking to the value of the property located within a specific geographic area. The Court found that the value of a railroad depends upon the whole line as a unit, to be used as a thoroughfare and means of transportation. A separate mile or two of its length is almost valueless. The Court approved a method enacted by the city of Cheyenne that taxed the value of the track within its city limits as a percentage of the value of the entire railroad line. In 1897, this concept of "unit" taxation was expanded to apply to a non-rail business that was operated in several states. In *Adams Express Co. v. Ohio* ((1897) 165 U.S. 194, 41 L.Ed. 683, 17 S.Ct. 305), the U.S. Supreme Court approved unit taxation for an express company. In *Adams Express*, Ohio's statute imposed a tax on "business property located in the state". The taxpayer argued that only its (minimal) tangible property physically located in the state could constitutionally be subject to taxation. The Court disagreed,

reasoning that the property within the state contributes to the taxpayer's aggregate value not merely the separate value of such tangible property. The Court sustained as constitutional Ohio's imposition of a tax on a proportionate share of the value of the entire business enterprise.

The next landmark in the development of unitary theory was the 1920 U.S. Supreme Court decision in *Underwood Typewriter Co. v. Chamberlain* (1920) 254 U.S. 113, 65 L.Ed. 165, 17 S.Ct. 305. This was the first case in which the U.S. Supreme Court approved the use of a formula to apportion the income of a single corporation among several states. In approving the formula used by Connecticut to determine the amount of income from a multistate business that was attributable to that state, the Court commented 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. At no time, however, did the Court refer to the operation as being "unitary."

The first express classification of a unitary business for state income tax purposes was made by the Court in the case of *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, (1924) 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82. In that case, the Court stated:

*"So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places - the process of manufacturing resulting in no profits until it ends in sales - the state was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business."*

In *Butler Bros. v. McColgan* ((1941) 17 Cal. 2d 664, 111 P.2d 334, aff'd 315 U.S.501), the California Supreme affirmed the unitary business principle of taxation and established a foundational "Three Unities" Test for determining whether business activities are "unitary". . The issue before the Court was whether a company's separate accounting for its California activities was sufficient to satisfy the taxpayer's burden of showing that factor apportionment was not "'fairly calculated' to assign to California that portion of the net income 'reasonably attributable' to the business done there". The Court affirmed the unitary business principle, explaining that separate accounting is only appropriate where a taxpayer's business within this state is truly separate and distinct from its business without this state. The Court reviewed the taxpayer's business and concluded that its "unitary nature" was established by the presence of the following circumstances: 1) Unity of Ownership; 2) Unity of Operation; and 3) Unity of Use (see MATM section 3030).

In *Edison California Stores v. McColgan* ((1947) 30 Cal.2d 472, 183 P.2d 16), the California Supreme Court extended the unitary concept to multiple entities. In that case, the business activity was carried on by a group of corporations rather than by divisions of a single corporation. The California Supreme Court validated the use of the unitary business concept to allow apportionment of the combined income of a multi-corporate group. (The U.S. Supreme Court validated the constitutionality of applying this concept to multiple corporations in *Container Corporation v. Franchise Tax Board* (1983) 463 U.S. 159, 77 L.Ed. 2d 545, 103 S.Ct. 2933.) *Edison California Stores* was also notable for establishing an alternative test (the "contribution / dependency" test) for unitary business: whether

the business operations in one state depend on or contribute to the business operations in another state. (See MATM section 3030.)

In *Superior Oil Co. v. Franchise Tax Board* ((1963) 60 Cal.2d 406, 386 P.2d 33), the FTB argued that the unitary concept was only applicable if the in-state activities could not reasonably be computed separately from the out-of-state activities. The California Supreme Court disagreed, holding that if a unitary business derives its income from sources within and outside the state, then formula apportionment is mandatory under the language of former R&TC section 24301 (now R&TC section 25101). (See also *Honolulu Oil Corp. v. Franchise Tax Board* (1963) 60 Cal.2d 417, 386 P.2d 40.)

## **3010 DIRECT INTEGRATION BETWEEN EACH SUBSIDIARY UNNECESSARY**

In the *Appeal of Monsanto Company*, 70-SBE-038, November 6, 1970, the California State Board of Equalization held that it is not necessary for the taxpayer's activities in California to be directly integrated with the activities of each other subsidiary everywhere in order for the subsidiaries' activities to be included in the California combined report. In that case, the taxpayer argued that its subsidiary, Chemstrand Corporation, was not a part of the unitary business because it did not contribute to or depend upon the California operation. Although Chemstrand had significant dealings with the taxpayer's operations outside the state, it had no direct dealings with the California facility, and none of the products sold by the taxpayer to Chemstrand had any connection with the taxpayer's California locations. The SBE rejected this argument:

*“This argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separate from either Chemstrand or the California operations.”*

Although the Chemstrand had no direct connections with its parent's California operations, it did have connections with its parent's out-of-state divisions. This concept was applied to separate corporations in *Appeal of Aimor Corporation*, 83-SBE-221, October 26, 1983. In *Aimor*, both a U.S. subsidiary and a Japanese subsidiary had ties with the Japanese parent, but neither subsidiary had any connection with one another. Citing *Monsanto*, the SBE held that all three corporations were engaged in a single unitary trade or business.

## **3015 BUSINESS OPERATING ENTIRELY WITHIN CALIFORNIA**

By its terms, R&TC §25101 applies only to taxpayers with income derived from or attributable to sources both within and outside the state. That section therefore does not extend the authority for combined reporting to corporations operating entirely within California. For taxable years beginning on or after January 1, 1980, R&TC §25101.15 allows two or more wholly in-state corporations to elect to determine their income in on a combined basis to the extent they share a common unitary business. (See also *Appeal of Tropicana Inn, Inc.*, 86-SBE-062, March 4, 1986.)

Currently, the department allows taxpayers to make this election on a year-by-year basis.

## **3020 APPLICATION OF THE UNITARY METHOD TO INTERNATIONAL BUSINESSES**

The unitary business principle extends to international business activities. The U.S. Supreme Court first approved the application of the unitary method to the international activities of a single corporation in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission* (1924) 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82. Since then, the Court has upheld the constitutionality of application of the unitary method to both domestic-owned and foreign-owned groups of corporations with multinational business(es). (E.g., *Container Corporation v. Franchise Tax Board* (1983) 463 U.S. 159, 77 L.Ed.2d 545, 103 S.Ct. 2933; *Barclays Bank PLC et al. v. Franchise Tax Board* (1994) 512 U.S. 298, 129 L.Ed.2d 244, 114 S.Ct. 2268)

Barclays Bank PLC is a United Kingdom based multinational banking enterprise, and its case—involving a domestic subsidiary—was considered by the U.S. Supreme Court along with that of Colgate-Palmolive Co., a U.S. based manufacturer with foreign subsidiaries. According to the U.S. Supreme Court, worldwide combined reporting did not impose unreasonable compliance burdens in requiring the taxpayer to gather data on all the related domestic and foreign corporations. California permitted the use of approximations, which met due process requirements. In reaching its decision, the U.S. Supreme Court cited *Complete Auto Transit, Inc. v. Brady* ((1977) 430 U.S. 274, 279, 51 L.Ed.2d 326, 331, 97 S. Ct. 1076, 1079) in holding that, absent congressional approval, a state tax on interstate commerce violates the Commerce Clause if it:

- Applies to an activity lacking a substantial nexus to the taxing state;
- Is not fairly apportioned;
- Discriminates against interstate commerce; or
- Is not fairly related to the services the state provides.

The Court went on to hold that a tax affecting foreign commerce is subject to two additional criteria. Such a tax does not survive Commerce Clause scrutiny if it:

- Enhances the risk of multiple taxation; or
- Prevents the federal government from speaking with one voice in international trade.

The U.S. Supreme Court found that Barclays and Colgate met the nexus requirement, had not demonstrated the lack of a "rational relationship between the income attributed to the State and the intrastate values of the enterprise," and had not shown that the income attributed to California was "out of all appropriate proportion to the business transacted by the [taxpayers] in that State." The taxpayers' claim of unconstitutional discrimination was rejected because they had not demonstrated that California's tax system imposed inordinate compliance burdens on foreign enterprises. (California's "reasonable approximations" method of reducing the compliance burden for foreign multinationals was also held to satisfy the Due Process requirement.) The Court then held that California's use of the worldwide unitary method did not inevitably result in multiple taxation, and observed that some risk of multiple taxation may occur in whatever taxing scheme the State adopts. The fact that Congress did not prohibit worldwide combined reporting reinforced the Court's conclusion that Congress "had implicitly permitted" that method. The implication to be drawn was that Congress did not believe that worldwide combined reporting prevented the federal government from speaking with one voice. The ultimate holding was that "*the Constitution does not impede application of California's corporate franchise tax to Barclays and Colgate.*" (*Barclays Bank PLC v. Franchise Tax Board* (1994) 512 U.S. 298, 303, 129 L.Ed.2d 244, 253, 114 S.Ct. 2268, 2272.)

### **3030 DEVELOPMENT OF TESTS FOR DETERMINING UNITY**

In *Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, *aff'd* 315 U.S. 501, 86 L.Ed. 991, 62 S.Ct. 701, the California Supreme Court established the "three unities" test for determining the presence of a unitary business.

Butler Brothers was a foreign (non-California) corporation engaged in a wholesale dry goods and general merchandising business that operated in various states. Although each of the distributing outlets kept its own books of account, made its own sales, and otherwise handled many of its own functions, a central buying division ordered the goods for the outlets and thus received favorable prices because of volume purchases. Indirect expenses of the business such as executive salaries, corporate overhead, and the costs of operating the central buying division and a central advertising division were allocated to each outlet by recognized accounting principles, the accuracy of which was stipulated by both parties. Using separate accounting, the California operations generated a loss, but overall the corporation made a profit. The applicable California statute applied a three-factor apportionment formula to the taxpayer's overall profit.

The issue before the Court was whether this apportionment method violated the Due Process Clause by unfairly or unreasonably representing the relative contribution of the taxpayer's business in California. The Court reasoned that the answer to this question was dependent upon the nature of the California operation relative to the whole of the taxpayer's business: if the operations were unitary then formula apportionment was reasonable based on the unitary principle; if the California operations were "truly separate and distinct", then a separate accounting was appropriate. Thus, the Court narrowed the issue to unity, finding that the California operation was unitary with the taxpayer's other business operations based on its analysis of the "three unities":

*" [I]t is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operations." (Butler Bros., 17 Cal.2d at 678.)*

The California Supreme Court was again required to determine whether or not a business was unitary in the case of *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472. In analyzing the presence of unity in that case, the Court formulated the "contribution or dependency test,":

*"If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate."*

The California courts have consistently applied the three unities test and the contribution or dependency test over the years. In the early eighties, however, the U.S. Supreme Court also began to refer to a unitary business as one that exhibits "contributions to income resulting from functional integration, centralization of management and economies of scale." (*F.W. Woolworth Co. v. Taxation and Revenue Dept. of the State of N.M.* (1982) 458 U.S. 354, 366, 73 L.Ed.2d 819, 102 S.Ct. 3128; *Mobil Oil Corp. v. Vermont* (1980) 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223.) Such contributions are evidenced by a flow of *value* (not necessarily a flow of goods) between the components of the business operations (*Container Corp. of Am. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 77 L.Ed.2d 545, 103 S.Ct. 2933). These judicial interpretations are often viewed as variations of the contribution or dependency test.

In [FTB Notice 1992-4](#), the department stated its policy that each of the above judicially acceptable tests apply with equal force, and that a finding of unity will result when any one of the tests has been met. The Notice also points out that the test in CCR section 25120(b), which requires a determination of unity "if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole," has been interpreted as consistent with the judicially established tests. In *A.M. Castle & Co. v. Franchise Tax Board* (1995) 36 Cal.App.4th 1794, the California Court of Appeal confirmed that the three unities and contribution or dependency tests are alternative tests, and that as long as one of the tests has been met, unity will not be denied just because the other test is not also met.



## 3035 APPLICATION OF THE UNITARY TESTS

Although the focus of the analysis may differ slightly between the unitary tests, the factual development necessary for you to make a unitary determination is essentially the same for each test. Unity of ownership is always required, except for partnerships. This aspect of the unitary analysis is discussed in MATM 3050. Once ownership is established, you must determine the level of integration that exists for the functions and activities of the business. You then must determine which unitary test best fits the unique facts of the case and how it should be applied.

## 3040 THREE UNITIES TEST

In *Butler Brothers* (1941) 17 Cal.2d 664; affd, 315 U.S. 501, 86 L.Ed. 991, 62 S.Ct. 701, the California Supreme Court established the "Three Unities" necessary to find that business activities are components of a unitary trade or business:

- Unity of ownership
- Unity of operations, as evidenced by central purchasing, advertising, accounting, and management divisions; and
- Unity of use in a centralized executive force and general system of operations.

The Test is satisfied if all three of the unities are found to be present.

The court in *Chase Brass & Copper Co., Inc. v Franchise Tax Board* (1970) 10 Cal.App.3d 496, provides a guidance of the difference between "operation" and "use":

*"Although there is not a clear demarcation between what is 'operation' and what is 'use,' in general it may be said that the acts falling within the category of 'operation' are the staff functions, and those within 'use' are the line functions."*

You should develop all the facts pertaining to unity. Although a discussion of the distinction between unity of use and unity of operation is being presented to help you recognize when these unities are present, an actual demarcation of the facts between unity of use and unity of operation is not critical at the audit level.

### Unity of Ownership

To satisfy constitutional requirements, it is necessary that there be "some bond of ownership or control" to establish that business activities are unitary. (*Container Corp. of Am. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 77 L.Ed.2d 545, 103 S.Ct. 2933.)

Generally, unity of ownership is present if there is common ownership or control of more than 50 percent of the voting stock of each corporation (R&TC section 25105). The ownership or control may be direct or indirect, as shown by the following examples:

### **Example 1**

Corporation A owns 50 percent of the stock of Corporation B and 25 percent of the stock of Corporation C. Corporation B owns 26 percent of the stock of Corporation C.

Corporation A does not own more than 50 percent of B, and B does not own more than 50 percent of C. Because A does not have a controlling interest in B, B's shares of C are not indirectly controlled by A. Therefore, A's direct and indirect interests in C are not sufficient to meet the ownership requirement. Unity of ownership is not present with respect to A, B, or C.

### **Example 2**

Assume the same facts as in Example #1, except that A now owns 51 percent of the stock of B. All three corporations would now meet the ownership test. Because A now has a controlling interest in B, it indirectly controls 26 percent of C through B. When this indirect interest is added to A's 25 percent direct interest in C, ownership of more than 50 percent is established. Accordingly, in this example, A has unitary ownership over C and B because it directly or indirectly owns and controls more than 50% of each.

### **Example 3**

Corporation A owns over 50 percent of the voting stock in Corporations B, C, and D. Corporations B, C, and D are unitary amongst themselves, but not unitary with Corporation A. Because Corporations B, C, and D are commonly owned, the ownership requirement has been satisfied and B, C, and D should file on a combined reporting basis even though A will not be included in the combined report. ([FTB Legal Ruling 410.](#))

In the majority of cases, the ownership determination is relatively straightforward. Occasionally, issues arise concerning family ownership, joint venture corporations, and other situations for which treatment under the code is not clear cut.

For taxable years beginning before January 1, 1995, FTB [Legal Ruling 91-1](#) reflects the current department policy with respect to unity of ownership.

For taxable years beginning on or after January 1, 1995, R&TC §25105 provides a bright-line test for unity of ownership. Following is an overview of the ownership requirements. For detailed explanations and definitions relevant to an ownership determination, you should refer to the statute.

Ownership requirements for combined reporting will only be met with respect to corporations that are members of a "commonly controlled group," defined as follows:

- A group of corporations that is connected through stock ownership (or constructive ownership) with a parent corporation. This criterion will be met if the parent owns more than 50 percent of the voting stock of at least one corporation, and if more than 50 percent of the voting stock of each other corporation is cumulatively owned by the parent and/or by another corporation that

meets the ownership requirements. (Examples #1 and #2 in the first part of MATM section 3040 are illustrative of how this rule works.)

- Any two or more corporations whose voting stock is owned (or constructively owned) more than 50 percent by one person. (Corporations are included in the definition of "person" found in R&TC §25105(f)(2).)
- Any two or more corporations that constitute "stapled entities" as defined in R&TC §25105(b)(3).
- Any two or more corporations whose voting stock is owned, without regard to family constructive ownership rules, by members of the same family. An exception to this rule may be made if the taxpayer establishes that the family ownership does not constitute direct or indirect control by the same interests, within the meaning given to that term in IRC §482.

If a corporation is eligible to be treated as a member of more than one commonly controlled group under these rules, the corporation must elect one group with which to be recognized as a member. Once the election is made, it will remain in effect unless revoked with the approval of the FTB. If a corporate member of a commonly controlled group ceases to meet the ownership requirements for a period of time, but meets the requirements again within two years, the FTB may treat that corporation as a member of the commonly controlled group for the entire time.

## Unity of Operations

Unity of Operation, according to *Butler Bros.*, is evidenced by central purchasing, advertising, accounting and management divisions. It is generally represented by functions that are normally labeled "staff" in administrative theory. (*Container Corporation of America v. Franchise Tax Board* (1981) 117 Cal.App. 3<sup>rd</sup> 988.) Examples of staff functions that are considered in determining the presence of unity of operations may include functions such as:

- Central purchasing;
- Manufacture and intercompany sale of products by one corporation to another member of the group for use as supplies, raw materials, component parts, packaging, or production equipment;
- Sharing of technology or information relating to products produced by the group;
- Joint distribution or storage of products;
- Transfers of equipment used in the business;
- Common advertising;
- Centralized accounting, legal, or personnel functions;
- Common insurance policies, pension plans or employee benefits;
- Intercompany financing, when such financing serves more than a mere investment function (including subordination of intercompany debt so that third party debt takes a higher repayment position);
- Shared use of brands, trademarks, patents, licenses, and other intellectual property; and
- Elevated credit rating due to financial strength of affiliate.

This list is by no means all-inclusive. Furthermore, you must realize that the mere listing of central operating departments will carry little value in the audit report if the taxpayer is successful in arguing that the connections are of little importance. You must describe the extent of the centralization, and document the benefits derived by the corporate group from the centralized operating departments.

For example, common purchasing might be a very significant unitary factor if the key raw material used by each member of the group is centrally purchased at a substantial volume discount. On the other hand, if the products that are centrally purchased consist only of miscellaneous supplies, the centralization of the purchasing function will carry much less importance.

By the same token, centralized accounting may be significant if a single accounting office performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each subsidiary in the group. Often, however, the term "centralized accounting" is used to describe a situation where a parent corporation compiles the data to prepare the consolidated Form 1120 tax return and retains the services of an outside accountant to perform the annual audit. These are tasks that are necessarily performed by a single corporation on behalf of virtually any affiliated group, regardless of the level of integration that otherwise exists between the members. Consequently, common tax return preparation and common financial statement preparation will not carry any weight in a unitary context.

Intercompany financing has often been held to be "substantial evidence of unity of operation" (*Chase Brass & Copper Co., Inc. v. Franchise Tax Bd.* (1970) 10 Cal.App.3d 496). It is important, however, that you determine the purpose of the financing. As explained in *Tenneco West, Inc. v. Franchise Tax Board*, ((1991) 234 Cal.App.3d 1510, 1532), financing is not a unitary factor when it primarily serves to diversify the corporate portfolio and reduce the risks inherent in being tied to one industry's business cycle. The court distinguished such financing from an investment in subsidiaries which functions to make better use of business-related resources through economies of scale, operational integration, or sharing of expertise.

Taxpayers may argue that the centralized functions performed by one corporation on behalf of another corporation did not result in any cost savings because the service or product could have been purchased for the same price from an outside source. Even if quantifiable cost savings are not present, the corporations may realize intangible benefits from the centralized functions. For example, in the *Chase Brass* decision, the taxpayer purchased approximately 20 percent of the copper produced by its parent corporation. Although the copper was sold for the same price charged to the taxpayer's competitors, the court stated, "to have a buyer of a substantial portion of the parent's production throughout the years must be assumed to be an advantage."

To anticipate and overcome this argument, you need to pinpoint the benefits achieved by the centralized function. Although it is difficult to isolate an intangible benefit such as an assured source of supply, you must document as many facts surrounding the function as possible to help demonstrate the benefits and prevent the taxpayer from minimizing the importance of the function as a unitary factor. For example, you may try to determine why the taxpayer established a particular type of centralized function and how long the function has been centralized in that manner. At the time that a function becomes centralized, there will usually be a good deal of documentation concerning the transition. You can review corporate minutes, internal correspondence, reports

identifying or justifying the need for centralization, and company newsletters to reveal the benefits achieved by the centralization.

## **Unity of Use**

Unity of use relates to executive forces and operational systems. The presence of unity of use is reflected in the integration of executive control over the major policy matters of the business. Some factors which have been used to support a finding of unity of use include the following (list not all-inclusive):

- Intercompany transfer of products
- Shared of officers and directors
- Transfer of executive personnel
- Submission of monthly financial statements
- Uniform theory of management
- Training
- Interchange of knowledge and expertise both formal and informal
- Public presentation or image
- Management philosophy

A centralized executive force will control the direction of the various activities and will ensure that they are operated in a manner most advantageous to the unitary business as a whole. The development of vertical (manufacturer/distributor) or horizontal (same type of business) relationships to maximize the profitability of the group are examples of how common executive control binds the operational systems of the business. Substantial intercompany sales or product flow, or the intercompany transfer of knowledge and know-how also constitute unity of use.

The general operation of a group of affiliates for the benefit of the group as a whole may be contrasted with a situation where common officers and directors are concerned only with maximizing the profitability of each individual corporation but without regard to each corporation's role in the group as a whole.

To determine where the major policy matters for each entity in the group are decided, you should look beyond the organization charts. Although the organization charts will identify the chain of command and show the reporting lines from the president down through the business segments, you need to gain an understanding of the involvement and control that takes place at each level of management. Audit techniques for obtaining this information are discussed beginning in MATM 3500.

The three unities test is often easiest to apply in a horizontally integrated enterprise. Because the various segments of the business are engaged in the same activity, they are most likely to have significant centralized staff functions such as centralized advertising or purchasing that are designed to give advantages to the business despite geographic differences (*Chase Brass, supra*).

## 3045 CONTRIBUTION OR DEPENDENCY TEST

The California Supreme Court in *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, stated that unity was present when the operation of the business done within California "is dependent upon or contributes to" the operation of the business done outside the state.

For some time, the department deduced that the contribution or dependency test was most easily satisfied by the presence of intercompany sales of tangible personal property. An example of this would be a parent corporation manufacturing the product that is sold by a subsidiary to customers in this state. However, in *Superior Oil Co. v. Franchise Tax Board* (1963) 60 Cal.2d 406, 386 P.2d 33, the Court found that contribution or dependency existed with respect to areas that included executive policymaking, coordination of activities, training of personnel, research, financing, and numerous other functions. As can be seen from this decision, the contribution or dependency test is generally based on the same functions and activities used to determine a unitary business under the "operations" and "use" tests.

The contribution or dependency test was clearly endorsed as an alternative test for unity in *A.M. Castle & Co. v. Franchise Tax Board* (1995) 36 Cal.App.4th 1794. In this case the question was whether a parent company, which sells metal products, was unitary with a subsidiary, which distributes metal alloy shapes. In sustaining the FTB's finding of unity, the court stated that this "is a classic case of a larger parent purchasing a smaller subsidiary to better utilize its existing resources, and to capitalize on the synergy between the two companies." The court considered whether the taxpayer was unitary under the three unities test. It stated that the taxpayer can make "a colorable issue that there was no unity of operation." However, the court decided not to rule on unity of operation, as Castle and Hy-Alloy were unquestionably unitary under the dependency or contribution test. The court also found that there was no constitutional constraint that requires use of the three unities test. The court can apply any test to determine unity as long as there is a flow of value between the segments in question.

The Court of Appeal's decision is consistent with [FTB Notice 1992-4](#). This FTB notice states that unity can be established under any one of the judicially accepted tests, and unity "cannot be denied merely because another of those tests does not simultaneously apply."

## 3060 UNITARY INDICATIONS

CCR § 25120(b) provides guidance regarding what is considered to be a unitary business. Most significantly, the Regulation sets forth three factors, the presence of any one of which will create a strong presumption that the activities of the taxpayer constitute a single trade or business. These factors are as follows:

(1) *Same type of business*: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer,

who operates a chain of retail grocery stores, will almost always be engaged in a single trade or business.

(2) *Steps in a vertical process:* A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

(3) *Strong centralized management:* A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

The SBE discussed the application of this Regulatory presumption in *Appeal of Sierra Production Service, Inc.*, 90-SBE-010, September 12, 1990. When the party seeking the benefit of the presumption establishes by "specific, concrete evidence" that one of the CCR §25120(b) factors apply, then the business is presumed to be unitary. This presumption may be rebutted, but the burden is on the opposing party to demonstrate "concrete evidence sufficient to support a finding that a single integrated economic unit did not exist." In other words, the presumption may only be overcome with evidence that the activities are not unitary under any of the established tests (e.g., three unities, contribution or dependency). If the presumption is successfully rebutted, then it disappears, and the burden shifts back to the party seeking combination to provide evidence to compel a determination that a unitary business exists. In [FTB Notice 1992-4](#), the department acknowledged that it is following these procedures for applying the presumption.

The fact that a taxpayer does not meet any of the three factors under CCR § 25120(b) simply means that no presumption of unity applies. No presumption of non-unity is created.

## **3065 SAME TYPE OF BUSINESS**

CCR § 25120(b) uses a chain of grocery stores as an example of activities that are in the same line of business. In practice, however, various activities may have similarities but may not be as identical as

a chain of grocery stores. In the following decision, the California Court of Appeals expressed its interpretation of what it takes for two corporations to be engaged in the same type of business.

In *A.M. Castle & Co. v. Franchise Tax Board* (1995) 36 Cal.App.4th 1794, the court found that the taxpayer and its subsidiary were in the same line of business and therefore satisfied one of the principles set forth in the regulations. However, this fact by itself was not determinative for the court. The court looked to the reason behind the regulation, the ability to make better use of its resources, and concluded that the reason was present in this case. Analyzing the facts of the case beyond the regulatory presumption, the court went on to analyze the case under both the three-unities test and contribution or dependency test.

In *A.M. Castle & Co.*, the parent company's (Castle's) business involved buying bulk metals from various mills, and then warehousing and processing those metals for resale to industrial customers. The parent acquired a subsidiary (Hy-Alloy), which distributed specialty metal alloy shapes. In arguing that Castle and Hy-Alloy were not in the same general line of business, the taxpayer relied on SBE decisions which construed '*activities in the same general line*' in an extremely narrow manner (*Appeal of Doric Foods Corp.*, 90-SBE-014, December 5, 1990 (since depublished), and *Appeal of Mohasco Corp.*, 83-SBE-098, October 14, 1982). The court pointed out that precedents made by administrative tribunals such as the SBE do not bind courts. But even if the cited decisions did have precedential value, the court indicated that it would decline to follow them.

The court then expressed its view that "two corporations are engaged in the same 'general line' of business when: (1) the two businesses are similar (but not necessarily identical); and (2) after the two corporations are combined, it permits the parent corporation to make better use of its existing business related resources. This may be done through 'economies of scale,' 'operational integration,' or 'sharing of expertise.'"

In this case, the acquisition of Hy-Alloy "permitted Castle to use its existing distribution system to service a new (though closely related) market." Therefore, the court found that Castle made "better use of its existing business related resources" when it purchased Hy-Alloy. Accordingly, the court concluded that the requirements of the contribution or dependency test were satisfied.

The following SBE decisions also provide some guidance in determining what is considered the "same type of business":

The *Appeal of Unitco, Inc.*, 83-SBE-121, June 21, 1983, involved a taxpayer that was engaged in the rental of improved real property. The taxpayer's investments included rentals of real property within and without California. At issue was whether all of the taxpayer's rental activities constituted a unitary business. Although the taxpayer had managed its properties in the past, by the appeal years another company was managing the properties for a fee. During the appeal years, the taxpayer's three officers played a very limited role in the decision-making for the properties.

The FTB sought to combine the various rental activities into a single unitary business, stating that the case presented a vivid example of a single corporation engaged in identical activities in four separate states, totally dependent upon the three officers to make the major policy decisions and, in some cases, to provide day-to-day guidance. The FTB also emphasized that where a taxpayer is engaged



in the same type of business, a strong presumption of unity is created. The SBE disagreed, finding that each rental activity was separate and distinct:

"In no way do any of appellant's rental activities contribute to or depend upon any of the others for their success or failure. Due to the disparate nature of each of appellant's property interests and the lack of any significant common relationship between them, we cannot conclude that these activities constitute a single economic unit."

The SBE dismissed the FTB's arguments with respect to the CCR §25120(b)(1) presumption, stating, "The simplest answer to this contention is that the presumption is not conclusive. When read in its entirety, the record will not support a conclusion that appellant's rental activities constitute a single unitary business."

The *Appeal of The Hearst Corporation*, 92-SBE-015, June 18, 1992, was another case in which the taxpayer successfully overcame the CCR §25120(b)(1) presumption. The taxpayer was engaged in various businesses such as television and radio broadcasting, cable communications, real estate, and the publication of newspapers, books, and magazines such as *Cosmopolitan* and *Good Housekeeping*. A wholly owned subsidiary of the taxpayer operating in the United Kingdom also published books and magazines, including U.K. editions of *Cosmopolitan* and *Good Housekeeping*. Pursuant to a licensing agreement, the taxpayer received royalties from the U.K. subsidiary for *Cosmopolitan* sales. The U.K. subsidiary was locally managed, had its own editorial staff, and its own accounting, advertising, legal, purchasing, insurance, and marketing divisions. The cover designs, layouts, and photographs for the magazines were done separately. Although the U.K. subsidiary was entitled to use material published in the U.S. edition of *Cosmopolitan*, less than 4 percent of the U.K. articles consisted of the U.S. material. Common advertisements and intercompany sales were minor.

The SBE was not persuaded by the similarities in format between the U.S. and the U.K. editions of *Cosmopolitan* and *Good Housekeeping*. While portions of the publications were similar, the same format was also used by a number of similar magazines published by competitors and other unrelated companies. The taxpayer had demonstrated that very few ties existed between the U.S. and U.K. operations, and there was no evidence that the contributions and dependencies that commonly exist between similar activities were present in this case. The SBE concluded that the "same line of business" presumption had been overcome, and that the U.S. and U.K. operations were operated as independent, nonunitary operations.

In the *Appeal of Quaker State Oil Refining Corp.*, 87-SBE-070, October 6, 1987, the SBE also commented upon whether the taxpayer was in the same business as its subsidiary although the §25120(b)(1) presumption was not applied. At audit, FTB determined the taxpayer was not unitary with its subsidiary as they were engaged in different businesses; the taxpayer was engaged, primarily, in refining oil and marketing petroleum products while Valley Camp (subsidiary) mined and sold coal to utilities and industrial companies. The taxpayer, on the other hand, contended that both were engaged in the same line of business, fossil fuel energy. Because of lack of evidence of commonality of operations or transferability of technology between the activities, the SBE did not find activities in superficially similar businesses to be unitary.

## 3070 STEPS IN A VERTICAL PROCESS

In a vertically integrated enterprise, various components of the business perform successive steps necessary to produce a finished product. The Regulation contains an example of a taxpayer, which explores for and mines copper ores, and performs the processes necessary to transform that ore into consumer products. Other examples would be an integrated oil company, or a timber company that cuts and logs timber, mills the lumber, makes plywood and other products, and sells the finished lumber products. In the following case, vertical integration took the form of a soft drink concentrate manufacturer that acquired a bottler and distributor of its products:

In *Appeal of Dr Pepper Bottling Co. of Southern California*, 90-SBE-015, December 5, 1990, the taxpayer produced, bottled, canned, and distributed soft drinks, including Dr Pepper. The taxpayer was acquired by Dr Pepper Company (DPC), a company that manufactured, marketed, sold, and distributed nationwide soft drink concentrates and syrups, primarily Dr Pepper and sugar-free Dr Pepper. Over 50 percent of the taxpayer's concentrate and syrup purchases were from DPC, and more than 50 percent of the taxpayer's sales were of Dr Pepper soft drink products. The taxpayer argued that the taxpayer was not unitary with DPC, and attempted to minimize the importance of its intercompany sales by pointing out that the sales amounted to only 1 percent of DPC's total annual sales, and only 9 to 13 percent of the taxpayer's total purchases.

Citing *John Deere Plow Co. v. Franchise Tax Board* ((1951) 38 Cal.2d 214) and CCR section 25120(b)(2), the SBE observed that the taxpayer's arguments ignored the fact that a vertically integrated business enterprise has consistently been regarded as a classic example of a unitary business. The Dr Pepper syrup was an essential component for a product, which made up a substantial part of the taxpayer's sales, and the taxpayer could not get that syrup from any other source. Also, the taxpayer provided an outlet for DPC's product. The SBE found that the fact that DPC maintained similar licensing agreements with 500 different bottlers (most of which were not company owned) did not diminish the unitary significance of the arrangement. Basing its decision primarily on the existence of vertical integration, the SBE sustained the FTB's determination that the companies were unitary.

## 3075 STRONG CENTRALIZED MANAGEMENT AND CENTRALIZED DEPARTMENTS

A taxpayer seeking the benefit of the CCR § 25120(b)(3) presumption must establish the presence of both "strong centralized management" and "centralized departments" for such functions as financing, advertising, research, or purchasing. In footnotes to its decision in *Appeal of Sierra Production Service*, 90-SBE-010, September 12, 1990, the SBE discussed its interpretation of these terms:

*What constitutes 'strong central management' will depend, to a considerable extent, on the facts in the particular case. We can say, however, that it requires more than the*

*mere existence of 'common officers or directors' or an allegation that the various business segments were under the ultimate control of the same person or group of people. The regulation clearly contemplates that the central managers will, among other things, play a regular operational role in the business activities of the various divisions or affiliates. The significance of such a managerial role, in the constitutional context, was underscored by the Supreme Court in Container."*

*There is no question that the regulation does not contain an all-inclusive list of the services which might be centralized, and which might provide evidence of unitary integration. Similarly, it should be clear that proof of a 'centralized department' requires something weightier than merely alleging, for example, that there was a 'common accountant' who kept the books for each affiliate. Other trivialities like a 'common insurance agent' will likewise be insufficient.*

Unlike the first two presumptions, the CCR § 25120(b)(3) presumption may be applied to diverse businesses that do not exhibit the more measurable indicators of unity such as intercompany product flow or sharing of product-related knowledge and expertise. A great deal of controversy has surrounded the application of this presumption.

The following string of cases has shaped the department's approach for dealing with the CCR section 25120(b)(3) presumption:

The *Appeal of Sierra Production Service, Inc.*, 90-SBE-010, September 12, 1990, involved the decombination at audit of an oil and gas well-servicing firm and a general aviation sales and service firm. The FTB's position was that the lack of "functional integration" between the companies precluded a unitary determination. The SBE found the companies to be unitary based upon evidence of mutual interdependence and flows of value sufficient to establish that the companies were a "*single integrated economic enterprise*," rather than on the basis of the CCR § 25120(b)(3) presumption. Notwithstanding this fact, the decision is important in the context of the (b)(3) presumption because of the relationship that the SBE found between that presumption and the combination of diverse businesses.

Specifically, the SBE disagreed with the implication that diverse businesses are presumptively nonunitary if "functional integration" is lacking. The SBE stated that the (b)(3) presumption operates to put diverse businesses with strong central management and centralized departments on equal footing with affiliated entities engaged either in the same general line of business or in different steps in a large, vertically structured enterprise.

In *Mole-Richardson Co. v. Franchise Tax Board* (1990) 220 Cal.App.3d 889, the taxpayer was primarily engaged in the design, manufacture, rental and sale of specialized lighting equipment in California, but also had farm and ranch operations in Colorado. Although the operations of these businesses were not integrated, the court concluded that the companies were nonetheless "functionally integrated" and entitled to file a combined report. The court found that the evidence in the case:

"established that respondent had a strong centralized management in that all major business decisions were made by Warren K. Parker. All accounting, payroll, insurance, pension plans, primary banking, major purchasing and advertising for the Colorado business as well as the California business was conducted at the Hollywood offices. In managing certain operations from one location the enterprise was able to realize cost savings, resulting in economies of scale. Real property in Hollywood was mortgaged to fund improvement of the ranch property in Colorado. One California attorney acted as general counsel for all businesses . . . . We are satisfied that based on the evidence in this case the operations of respondent were functionally integrated and respondent was entitled to tax treatment as one unitary business."

This was the first major "diverse business" decision, and it established that activities could be unitary based upon strong centralized management and centralization of non-operational functions.

In *Dental Insurance Consultants, Inc. v. Franchise Tax Board* (1991) 1 Cal.App.4th 343, the issue was whether Dental Insurance Consultants, Inc. (DIC) and its wholly owned subsidiary were engaged in a unitary business. DIC was primarily engaged in providing review and advice regarding dental insurance claims for various insurance companies, and its wholly-owned subsidiary operated a number of small farms. With one exception, the officers and directors of the farm subsidiary also served as officers and directors of DIC. Functions such as accounting, bookkeeping, purchasing insurance, and check-writing services were provided to the farm subsidiary by DIC. DIC lent the farms money, and provided guarantees for a number of farm obligations. Although unrelated management firms conducted the daily operations of the farms, the ultimate policy decisions were the responsibility of the common directors. The president and majority shareholder of DIC, Richard Guenther, had an active role in the farm operations. He approved all checks issued by the farms, and approved such decisions as deepening a well, repairing wind machines, establishing the mix of a product, and installing a drip irrigation system. Guenther and another common officer negotiated and executed the farm management agreements. Guenther also applied for water delivery on behalf of the farms, and executed an agreement with the irrigation district regarding the installation of a pump.

The court found the management role played by DIC and Guenther to be much more than the occasional oversight any parent routinely gives to an investment in a subsidiary. Therefore, even though independent management firms performed the daily activities of the farms, the court concluded that the farms were not operated independently: "The close control by DIC and the shared administrative functions, coupled with undisputed unity of ownership, establish the requisite economic, operational and managerial interdependence to establish the unitary nature of these businesses." This decision indicates that strong centralized management can exist even though the day-to-day management is independent.

In contrast, the California Court of Appeal in *Tenneco West, Inc. v. Franchise Tax Board* (1991) 234 Cal.App.3d 1510, 286 Cal.Rptr. 354, petition for review denied, January 30, 1992, found that strong centralized management did not exist. The taxpayer had asserted that Tenneco and its subsidiaries were engaged in a single unitary business. The FTB had conceded that Tenneco was unitary with its oil-related subsidiaries (the businesses included land, gas, pipeline, agricultural and chemical activities), but determined that unity did not exist with respect to the remaining subsidiaries (excluded subsidiaries). The excluded subsidiaries were engaged in various activities, including shipbuilding, packaging, and manufacturing of automotive parts and construction equipment.

In numerous public documents, policy manuals and speeches, Tenneco had portrayed its operations as autonomous and highly decentralized. Although some centralization existed with respect to various functions, the court found the substance of that centralization to be minimal. For example, although Tenneco had a legal department, each of the major divisions also had its own legal staff. Tenneco's tax department handled federal, ad valorem, and property tax matters, but each subsidiary filed its own state tax returns. The subsidiaries handled their own accounting and financial activities, although those activities were reviewed and periodically audited by Tenneco's central accounting and internal audit departments.

The taxpayer attempted to establish strong centralized management through Tenneco's policy control, but the court found that control to be neither strong nor uniform. The court stated:

"[M]ost of Tenneco's business strategy and activities -- including the annual planning process, weekly meetings between the chief executive officer and executive committee, internal audit, corporate-wide procedures manual, financial strategy with debt targets and dividend payout ratios, approval of major capital expenditures, external financing, cash management, real property disposition, guaranties, loans and advances to and from divisions, insurance, and overruling subsidiaries' ideas -- constituted 'the kind of behavior that one would expect to find in any parent subsidiary or parent division relationship'."

Because strong centralized management and centralized departments were not present, the CCR § 25120(b)(3) presumption of unity did not apply. The court went on to find that the activities of the Tenneco excluded subsidiaries were not so integrated with Tenneco's oil related businesses or with each other so as to constitute a unitary business.

Although the courts have not provided a precise definition of strong centralized management, the current court and SBE decisions appear to focus on involvement of managers in significant operational decisions with some regularity. This regular operational role may be distinguished from a lesser degree of management oversight over the results of a subsidiary's operations that is to be expected of any parent/subsidiary relationship. To determine whether there is strong centralized management, you must first acquire an in-depth understanding of the functions of the businesses under examination. You must define the major operations of the businesses and the major decisions affecting those operations. Then, you must identify the purported central managers and determine whether and to what extent those managers were involved in the major operational decisions of the businesses under examination.

In addition to commenting upon centralized management, the cases summarized above also discuss the unitary significance of "centralized departments" in the context of the CCR § 25120(b)(3) presumption. The following references to the issue are also instructive:

In the *Appeal of Hollywood Film Enterprises*, 82-SBE-052, March 31, 1982, the State Board of Equalization stated:

"[W]here there is no horizontal or vertical integration, some of the most significant unitary factors, such as intercompany product flow often will not exist. Therefore, factors, which might

be considered relatively insignificant in a case of horizontal or vertical integration, take on added importance because they are the only factors present to consider. Each case must be decided on its own particular facts. . . ."

In the *Appeal of Saga Corporation*, 82-SBE-102, June 29, 1982, the State Board of Equalization stated:

"[A]ppellant, rather than respondent, bears the burden of proof, i.e., appellant must establish by a preponderance of the evidence that the unitary connections present in the case are, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist."

In *F.W. Woolworth Co. v. Taxation & Revenue Dep't* (1982) 458 U.S. 354, 370, 73 L. Ed. 2d 819, 831, 102 S. Ct. 3128, 3138, the U.S. Supreme Court, in finding that related retailing operations were not unitary, stated, *inter alia*:

"The Woolworth parent did not provide 'many essential corporate services' for the subsidiaries and there was no 'centralized purchasing office...whose obvious purpose was to increase overall corporate profits through bulk purchases and efficient allocation of supplies among retailers."

In discussing the unitary significance to be attached to the fact that Woolworth's published financial statements, such as its annual reports, were prepared on a consolidated basis, the high court cited to the following passage from Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 43, 52 (1960):

"Central accounting, for instance, may result in some savings, but in most instances the amount is trifling in comparison with the income [involved]. Alone considered it is too weak a connecting link to bind into one business, what would otherwise, from an operational standpoint, be considered separate businesses." (*F.W. Woolworth*, 458 U.S. at 368, fn.22)

In view of the above authorities, there is no single, universally applicable listing of centralized departments rising to unitary significance. Therefore, each case must turn on its particular facts.

In so-called "diverse business" opinions, the SBE has included the following paragraph:

"More is required to demonstrate the existence of a functionally integrated enterprise than the recitation of a number of so-called 'unitary factors.' One must be able to differentiate a unitary business from a group of commonly owned businesses or activities, the operations of which really have no effect upon one another. (*Appeal of Sierra Production Service, Inc., et al.*, 90 SBE-010, Sept. 12, 1990.) As we said in the *Appeal of Saga Corporation*, decided by this Board on June 29, 1982, we must distinguish between those cases in which unitary labels are applied to transactions and circumstances which, upon examination, have no real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single economic enterprise."

(See, e.g., Appeal of Merry Mary Fabrics, Inc., et al., 93-SBE-007, 04/22/1993)

As a general guide, the following list can assist you in evaluating the centralized department issue. This list is not exhaustive; nor is the absence of any item cited in the list as generally significant or important conclusive of whether a particular case satisfies the element of centralized departments under CCR § 25120(b)(3):

Generally Insignificant:

- Preparation of audited financial statements
- Preparation of tax returns
- Common purchases of insurance
- Centralized purchasing of office supplies
- Group discounts on items such as rental cars
- Legal services for matters such as SEC filings, shareholder relations, and public relations.

Generally Significant:

- Research and development
- Central purchasing of raw materials
- Shared sales force
- Use of common trade name substantially affecting customer purchasing decisions
- Common distribution systems
- Common inventory control
- Government relations (e.g. representing businesses to government regulatory entities)
- Centralized bookkeeping
- Pension and profit sharing
- Cash management, centralized borrowing, or treasury
- Personnel: hiring, EDP, and payroll
- Employee benefits
- Legal services for contract review
- Common headquarters building
- Labor relations
- Marketing and common use of logo (unconnected to common sales efforts)
- Central advertising offices (providing separate advertising services to each member, without common advertising of a product relationship between products of different members)
- Real estate construction
- Self-insurance

**FTB Notice 1992-4:**

The department has developed diverse business audit guidelines to conform the department's use of the CCR §25120(b) presumptions to the decisions in *Sierra Production Service*, *Mole-Richardson*, *Dental Insurance Consultants*, and *Tenneco West*. These guidelines have been published in [FTB Notice 1992-4](#). The key points are as follows:

- The tests for evaluating unity in diverse business cases are the same judicially established tests used for any other unitary determination (three unities, dependency or contribution, etc. – see MATM 3030). Unity cannot be denied merely because another of those tests does not simultaneously apply.
- If strong centralized management and centralized departments are present, unity cannot be denied solely because of a lack of operational (functional) integration. Diverse businesses are not presumptively nonunitary, and they do not require a higher burden of proof of unity.
- A unitary analysis must be based on evidence. While it may be useful to contrast the facts from one case to another, no two cases will ever be identical. Descriptive terms such as "strong centralized management" or "same type of business" are conclusory labels, and resolution of the unitary issue (including the application of such labels) should turn on an application of the established tests to the unique facts of each case.
- The CCR § 25120(b) presumptions of unity are important, but not conclusive, considerations in determining unity. The presumptions may be rebutted, and this topic is discussed in more detail in MATM 3060 - 3075.
- The Court of Appeals decisions in *Mole-Richardson* and *Dental Insurance Consultants* are controlling of the diverse business issue. To the extent that SBE decisions are not in accord with these court cases, the SBE decisions should not be relied upon.

For further information relating to the evaluation of strong central management, see MATM 3570. That section also lists sources of information that may be useful in developing this issue

## **3080 UNITARY COMBINATION OF HOLDING COMPANIES**

A holding company may be entirely passive, or may provide management and oversight functions to its subsidiaries. In either case, the activities of the holding company are generally limited. There are no unique unitary tests designed for holding companies. The standard unitary tests (e.g., three unities, contribution or dependency) must be applied. Because those tests were designed to fit the fact patterns that are typically found in operating companies, their application to holding company fact patterns is not always readily apparent. Two 1995 legal rulings (discussed below) define the department's position with respect to certain fact patterns involving holding companies. In cases that do not fall within those fact patterns, carefully analyze the facts and circumstances of the case and determine the relative significance of the flows of value that can be identified.

Following are summaries of the decisions that are most influential in shaping FTB's current policy towards holding companies.

In *Appeal of Fibreboard Corp.*, 87-SBE-002, January 6, 1987, the parent operating company held a holding company, which, in turn, held another operating company. The parent sold the stock of the



holding company, and the issue was whether the gain from the sale should be business or nonbusiness. In this particular case, the taxpayer was unable to establish that the two operating companies were engaged in a unitary relationship. Therefore, the gain was held to be nonbusiness. What is relevant in this context is the analysis that the SBE used to reach its conclusion.

Although the gain arose from the sale of the holding company stock, the SBE noted that the real issue was the lower tier operating company's relationship with the parent. The SBE's analysis focused upon whether the holding company stock "*or the assets it represented*" were integrally related to the parent's unitary business operations. Thus, the SBE apparently looked through the holding company to characterize the gain on the sale of holding company stock.

In *Appeal of Lakeside Village Apartments Inc.*, 92-SBE-022, July 30, 1992, a holding company acquired an apartment complex through a merger with a subsidiary that had been formed for that purpose. The holding company also held a group of other subsidiaries, Reliable Stores, which were engaged in activities entirely unrelated and dissimilar to those of the apartment subsidiary. The officers and directors of the former apartment corporation remained as officers and directors of the new corporation after the merger, and also joined the board of directors of the holding company. The apartment subsidiary paid \$25,000 annually pursuant to an agreement whereby it was required to look to the holding company for decisions regarding financial activities, tax matters, and accounting policies. The terms of the agreement also stated that the holding company was to provide certain centralized functions to its subsidiaries on the basis that its activities were viewed as a "single unitary group." As a result of a successful condominium conversion, the apartment subsidiary distributed \$5 million in dividends to the holding company.

The taxpayer failed to establish that the former officers of the apartment complex had managed anything other than the condominium conversion operations, just as they had done before the acquisition. The other officers and directors of the holding company had no involvement with the apartments, and their financial decision-making power was insufficient to support a finding of unity because it was the type of occasional oversight that any parent gives to an investment in a subsidiary. The SBE questioned the credibility of the management agreement because it did no more than outline the types of decisions that any parent makes for its subsidiaries, and seemed to serve no other purpose than to create apparent evidence of unity. The "intercompany financing" asserted by the taxpayer actually consisted only of the payment of dividends from the apartment subsidiary to the holding company, and was rejected as a unitary feature. The SBE concluded that the holding company and the apartment subsidiary were not unitary.

Note that unity between the holding company and its Reliable Stores subsidiaries was not addressed in this case.

The operating company in *Appeal of PBS Building Systems, Inc. and PKH Building Systems, Inc.*, 94-SBE-008, November 17, 1994, was found to be unitary with its holding company parent. The holding company was formed as a vehicle for a leveraged management buyout of the operating company's stock. The operating company made an interest-free loan to the holding company to fund the stock purchase. The holding company later refinanced the debt by issuing securities guaranteed by the operating company. The holding company also obtained a covenant not to compete from the former owners of the operating company.

The SBE emphasized that the standard unitary analysis (the three unities and contribution or dependency tests) is to be applied in determining whether a holding company and an operating company are unitary. The SBE rejected the generalization that "holding companies are essentially inactive and are per se incapable of providing or receiving a flow of value to or from an operating company." Instead, the SBE observed that because the typical characteristics of unity may not exist, the holding company context requires a focus on the economic realities of the particular corporate structure to determine whether unity is present. Citing *Appeal of Hollywood Film Enterprises*, 82-SBE-052, March 31, 1982, the SBE stated: "Factors which might be considered relatively insignificant in a case of horizontal or vertical integration take on added importance because they are the only factors present to consider."

The flows of value that the SBE found in this case included intercompany financing of substantial value to the holding company, substantial amounts of money expended by the operating company for the holding company's public debt offering, and the covenant not to compete entered into by the holding company to protect the operating company from its former owner. The complete overlap of officers and directors, when considered in light of the other integrating factors, was seen as further evidence of the operation of the companies as a unitary business. The SBE concluded that there was substantial evidence to support a finding of unity.

The *Appeal of National Silver Co.*, 80-SBE-117, October 28, 1980, and *Appeal of Allright Cal., Inc.*, 79-SBE-001, January 9, 1979, both involved situations where the holding companies provided services for their subsidiaries, and the SBE found them to be part of the unitary business. On the other hand, in the *Appeal of Power-Line Sales, Inc.*, 90-SBE-016, December 5, 1990, and *Appeal of Insul-8 Corp.*, 92-SBE-007, April 23, 1992, the SBE did not allow the holding companies to be included in the unitary group on the basis that the taxpayers had failed to meet their burden of proving a unitary relationship.

In November 1995, the department issued FTB [Legal Ruling 95-7](#) and FTB [Legal Ruling 95-8](#) explaining the department's position on combination of holding companies with operating companies in light of the SBE's opinion in the *Appeal of PBS/PKH*. FTB [Legal Ruling 95-7](#) deals with fact patterns in which a passive parent holding company holds one or more operating company subsidiaries, which are engaged in a single unitary business with each other. FTB [Legal Ruling 95-8](#) deals with fact patterns in which an intermediate passive holding company is held by a parent operating company and in turn holds one or more operating company subsidiaries, which are engaged in a single unitary business with the operating company parent. The rulings announce a broad rule of combination in the fact patterns described. Combination of passive holding companies in other fact patterns will depend upon the facts and circumstances of the case.

### **Legal Ruling 95-7 "Parent Holding Company"**

[FTB Legal Ruling 95-7](#) describes three fact patterns. In Situation 1, a passive parent holding company holds an operating company engaged in a single unitary business. In Situation 2, a passive parent holding company holds two operating company subsidiaries engaged in a single unitary business with each other. Situation 3 differs from Situation 2 in one respect: the holding company is held by an operating company which is not engaged in a single unitary business relationship with the

holding company's operating company subsidiaries. In each situation, the holding company dedicates virtually all of its activity to its operating subsidiary or subsidiaries.

FTB Legal Ruling 95-7 holds:

- Situation 1 – the holding company is unitary with and includible in a combined report with the operating subsidiary.
- Situations 2 and 3 – the holding company is unitary with and includible in a combined report with the two operating subsidiaries.
- Situation 3 – the holding company's operating parent is not includible in a combined report with the passive parent holding company and the two operating subsidiaries.

The ruling applied the *Edison California Stores* contribution or dependency test articulated in the general provisions of CCR section 25120(b) and in the SBE's decision in *Appeal of PBS/PKH*. It references PBS/PKH and the U.S. Supreme Court opinion in *Mobil Oil Corp. v. Commissioner of Taxes* ((1980) 445 U.S. 425, 63 L. Ed. 2d 510, 100 S. Ct. 1223) on the importance of looking to the underlying economic realities in determining the propriety of apportionability. It also references the SBE's analysis in *Fibreboard Corp.*, 87-SBE-002, January 6, 1987, where the SBE looked through an intermediate holding company and focused on the absence of a unitary relationship between the holding company's operating company parent and operating company subsidiary.

Applying the above principles, FTB Legal Ruling 95-7 concludes that when a passive parent holding company holds one or more operating company subsidiaries that are engaged in a single unitary business with each other, the holding company's primary function is as a conduit between the shareholders and the single unitary business operations they indirectly own. The unitary business is what gives the holding company value to the shareholders. The holding company represents the unitary company or group. It thus is an integral part of a unitary system, the parts of which contribute to or depend upon each other. Separating the holding company from the unitary operating company or group for combined reporting purposes places too much emphasis on form, when in substance there is but one unitary business. That underlying economic reality is not altered when, as in Situation 3, a nonunitary operating company holds a majority of the holding company's stock as a nonbusiness asset.

### **Legal Ruling 95-8 “Intermediate Holding Company”**

FTB [Legal Ruling 95-8](#) describes two fact patterns. In Situation 1, an intermediate passive holding company holds a single operating company subsidiary that is engaged in a single unitary business with the holding company's operating company parent. In Situation 2, an intermediate passive holding company holds two operating company subsidiaries, which are engaged in a single unitary business with the holding company's operating company parent. In each situation, the holding company dedicates virtually all of its activity to the operating company parent and subsidiary or subsidiaries.

FTB [Legal Ruling 95-8](#) holds that in both situations the holding company and operating companies are unitary and includible in a combined report with each other.

FTB [Legal Ruling 95-8](#) builds upon the reasoning of FTB [Legal Ruling 95-7](#). It applies the *Edison California Stores* contribution or dependency test, the economic realities principles articulated in *Mobil*

*Oil and the Appeal of PBS/PKH* and the "look through" analysis of the *Appeal of Fibreboard Corporation*. In addition, it cites *Appeal of Monsanto Co.*, 70-SBE-038, November 6, 1970, and its progeny and the U.S. Supreme Court opinion in *Barclay's Bank v. Franchise Tax Board* ((1994) 512 U.S. 298, 129 L.Ed.2d 244, 114 S.Ct. 2268) for the proposition that the unitary relationship between corporations included in a combined report may be indirect.

FTB Legal Ruling 95-8 concludes that when an intermediate passive holding company owns one or more operating company subsidiaries that are unitary with the holding company's operating company parent, the holding company's primary function is as a conduit that effectuates contributions or dependencies between the parent and the subsidiaries. The holding company performs a unitary function for the group by holding the stock of the lower tier operating company subsidiary or subsidiaries that would be a unitary business asset of the parent operating company if it were directly held by the parent. The holding company dedicates virtually all of its activity, however small, to the parent and subsidiary or subsidiaries. It is an integral part of a larger unitary system, the parts of which contribute to or depend upon each other. To separate the holding company for combined reporting purposes places too much emphasis on the form of corporate structure when the substance and underlying economic reality is that there is but one unitary business.

#### **Holding companies that own non-unitary subsidiaries:**

The department has announced that it will continue to follow the *Appeal of Lakeside Village Apartments*, 92-SBE-022, July 30, 1992. In *Lakeside Village*, the SBE denied combination of a passive parent holding company with operating company subsidiaries that were not unitary with each other. In contrast to the fact patterns presented in the *Appeal of PBS/PKH* and FTB Legal Rulings 95-7 and 95-8, in *Lakeside Village* there were two lines of business: an apartment concern and a retail stores concern, and there was no showing of unity between those two concerns or of unitary linkage through strong central management and centralized departments.

## **3085 INSURANCE COMPANIES**

Insurance companies may not be included in the combined report. (FTB Legal Ruling 385.)

The California Constitution (Article 13, section 28) generally provides for a tax based on gross premiums of most insurance companies doing business in California. With some exceptions such as taxes on real estate and motor vehicles, Article 13, section 28, subdivision (f) provides that the gross premiums tax "*is in lieu of all other taxes and licenses, state, county and municipal, upon such insurers and their property.*" The courts have held that this language effectively exempts insurance companies from the California franchise tax. (*First American Title Insurance & Trust Co. v. Franchise Tax Bd.* (1971) 15 Cal.App.3d 343, 93 Cal.Rptr. 177). [FTB Legal Ruling 385](#) (1975) explains that under authority of Article 13, section 28, a corporate insurer operating in California is barred from inclusion in a combined report, even if it is unitary. To accord uniform treatment on basically similar facts, the legal ruling goes on to state that it will be the department's practice to exclude from the combined report any insurance company operating entirely outside California. This exclusion from the

combined report applies to companies that are regularly engaged in an insurance business, and that are licensed as such and subject to regulation under the laws of the state(s) where they operate.

Before 1938, insurance companies were taxed on their gross premiums less amounts paid for reinsurance. The insurance company receiving the reinsurance premiums would pay tax on its premiums. State taxation of insurance companies was changed effective for 1938, in that insurance companies were taxed on their gross premiums without reduction for reinsurance premiums paid. Thus, reinsurance was not taxable on the basis that the insurance premiums had already been indirectly taxed. Accordingly, reinsurance companies are subject to the provisions of Article 13, section 28, and are therefore exempted from the franchise or income tax. (For an explanation of reinsurance, see MATM 5190.)

Note that an insurance company, which is excluded from the combined report under the California constitution, may still be unitary with or functionally related to its affiliates. The SBE has held that the stock of a unitary insurance company was integrally related to the unitary business operations of the corporate group even though the insurance company could not be included in the combined report. Therefore, the dividends received from the insurance company subsidiary were held to be business income. (*Appeal of Control Data Corp.*, *Commercial Credit Corp.*, 96-SBE-002, February 22, 1996.)

### **Captive insurance companies**

The FTB considers a captive insurance company to be an insurance company for purposes of Legal Ruling 385. The department's policy is not to combine captive insurance companies. (The issue in this context is the proper deduction for insurance expense. See R&TC section 24425(b) for more information; and see MATM 5190 for a discussion of captive insurance companies.)

## **3086 UNITARY COMBINATION OF PARTNERSHIPS**

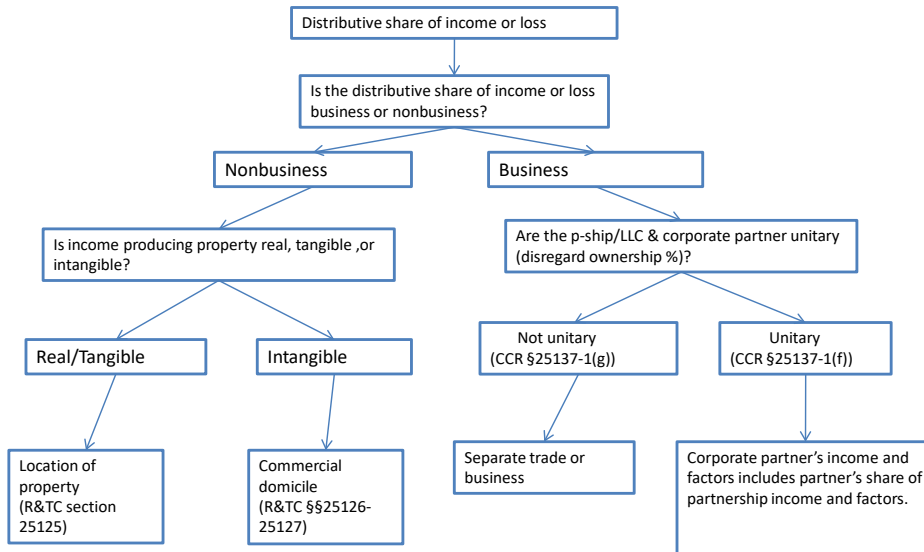
Disregarding the ownership requirement, use the same established standards (MATM sections 3000 et seq.) to determine whether a partnership's activities and its corporate partner's activities are unitary.

In the *Appeal of Saga Corp*, 82-SBE-102, June 29, 1982, the FTB argued that Saga Corp had a unitary relationship with the partnership. CCR §25137-1 did not apply retroactively to the taxpayer. However, the SBE found the reasoning behind that regulation compelling because a partnership is not an entity that is separately taxable from its partners. Accordingly, the SBE held that even if the corporate partner had a less than 50 percent interest in the partnership, combination of the income and factors of the partnership to the extent of the corporate partner's interest in the partnership was appropriate.

CCR § 25137-1 contains the rules for apportionment and allocation of partnership income. For additional information also see:

- MATM 4040 Partnership Interests
- MATM 5300 Partnership Income
- MATM 7195 Partnership Property
- MATM 7360 Partnership Payroll
- MATM 7570 Partnership Sales
- MATM 7705 Unique Apportionment – Partnership Income

If Regulation section 25137-1 applies:



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## 3087 UNITARY COMBINATION OF LIMITED LIABILITY COMPANIES (LLCs)

### Overview pertaining to limited liability companies

A limited liability company (LLC) is a hybrid business entity that combines aspects of both a partnership and a corporation. California LLCs are formed under the California Corporation Code and consists of "members" who are the legal owner(s) of the business, owning an intangible asset called membership interests in the LLC. Membership interests are analogous to partnership interests or to stock in a corporation. Members may be individuals, corporations, partnerships, or other limited liability companies. An LLC has a legal existence separate from its members and provides members with limited liability to the same extent enjoyed by corporate shareholders. Yet more like partnerships, LLCs may be structured to allow members to directly and actively participate in management and control. (*City of Los Angeles v. Furman Selz Capital Management LLC* (2004) 121 Cal.App 4<sup>th</sup> 505.)

Unless the articles of organization or operating agreement restrict the scope of the member's authority, every member of an LLC is an agent of the LLC for the purpose of its business or affairs.

(California Corporation Code section 17157.) When an agent conducts activity within the scope of his authority or which is subsequently ratified, the agent's principal is considered to have conducted that activity. (California Civil Code sections 2295 and 2330.)

An LLC may elect to be classified as a corporation for tax purposes. In this case, the LLC:

- Operates as an LLC for civil law (i.e. for all non-tax purposes). For income tax purposes, it is subject to the Corporation Tax Law (Part 11, Division 2, California Revenue and Taxation Code).
- Files Form 1120 for federal and Form 100, 100W, or 100S for California.
- Members are treated like shareholders. See examples of elective changes in classification under Treas. Reg. section 301.7701-3(g).

### **Overview of the "check-the-box" rules**

The Internal Revenue Service issued final regulations under section 7701, which greatly simplified the classification of business entities for federal tax purposes. These so-called "check-the-box" regulations became effective on January 1, 1997. (Treas. Reg. section 301.7701-1 et seq.) The classification of an LLC as an association taxable as a corporation or partnership must be made under California regulations, which must be consistent with federal "check-the-box" regulations in effect as of May 1, 2014. (R&TC § 23038(b)(2)(B)(i).)

Under the check-the-box regime, an eligible business entity can elect how it will be classified for federal tax purposes. The California classification will follow the federal classification. Under the check-the-box rules:

- A business entity that is a "per se" corporation is required to be taxed as a corporation. CCR § 23038(b)-2(b) contains a list of entities, both domestic and foreign, that are required to be taxed as corporations.
- A business entity that is not classified as a corporation is considered an "eligible entity" and can elect its tax classification as provided in Treas. Reg. section 301.7701-3. (CCR § 23038(b)-3.)
- A federal election is necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. (CCR § 23038(b)-3(a).) If an eligible entity does not elect a classification, its default classification will depend whether it is formed in the U.S. or in a foreign country. (CCR § 23038(b)-3(b).) For a domestic eligible entity, the default classification is:
  - A partnership if it has two or more members
  - Disregarded as an entity separate from its owner if it has a single owner(CCR § 23038(b)-3(b).)
- An eligible entity with:
  - Two or more members can elect to be classified as either an association taxed as a corporation or as a partnership. (CCR § 23038(b)-3(a).)
  - A single owner can elect to be classified as an association taxed as a corporation or be disregarded as an entity separate from its owner. (CCR § 23038(b)-3(a).) If the entity is

disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. (CCR § 23038(b)-2(a).)

- Even though a check-the-box classification change is in form only, the tax consequences of the change will be the same as if the entity had actually gone through the steps to change its structure. For example, if an entity classified as a partnership elects to be classified as a corporation, the partnership is deemed to transfer all its assets and liabilities to the corporation in return for stock, and immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners. (Treas. Reg. section 301.7701-3(g).)

### Tax Status of U.S. Legal Entities

U.S. Legal Entity	Tax Status
Sole proprietorship /branch/division	Not as separate entity from owner
Corporation	"C" or "S" corporation
General partnership	Partnership or corporation (check-the-box)
Limited partnership	Ltd partnership or corporation (check-the-box)
Limited liability partnership	Partnership or corporation (check-the-box)
2+ member LLC	Partnership or corporation (check-the-box)
Single member LLC	Not a separate entity or corporation (check-the-box)

### LLCs and combined reporting

In determining whether an eligible entity's activities and its corporate owner's activities constitute a unitary business, you will use the same established standards.(MATM sections 3000 et seq.) In addition, you should obtain:

- The articles of organization – This document spells out who is managing the LLC.
- The operating agreement – It describes the business activities of the LLC, and identifies whether the members delegate certain operational activities to a non-member,

If an eligible entity is classified as a:

- **Corporation** – An LLC electing to be taxed as a corporation is subject to the applicable provisions of the Corporation Tax Law:
  - R&TC section 25101 refers to "income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state. . ." (Part 11, Division 2, California Revenue and Taxation Code).



- R&TC section 23037 defines "taxpayer" to include "any person subject to the tax imposed under Chapter 2 (commencing with R&TC § 23400), Chapter 2.5 (commencing with R&TC § 23400) or Chapter 3 (commencing with R&TC §23501).
- R&TC section 25105 refers to "corporations" for purposes of determining ownership or control. For purposes of this section, "'Corporation' means a subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation pursuant to Section 23038 or 23038.5."
- R&TC § 23038(c) provides that "for purposes of exercising its franchise within this state, 'corporation' also includes any limited liability company that is classified as an association for California tax purposes."

For tax purposes, just like any other corporation, unitary business principles apply to an LLC that elects to be treated as a corporation. If unitary, it will be included in the combined reporting group with other corporations.

- **Partnership** – See MATM 3086.
- **Disregarded Entity** – If a single member LLC (SMLLC) does not affirmatively elects out of its default classification, it is deemed to be a branch or division of its owner. (CCR §23038(b)-2(a).) The assets and liabilities of a disregarded entity (DE) are treated as owned, and its activities are treated as actually performed by its single owner. The DE reports its income, deductions, and credits on the return of its owner. (*City of Los Angeles v. Furman Selz Capital Management LLC* (2004) 121 Cal.App 4<sup>th</sup> 505.)

The *City of Los Angeles v. Furman Selz Capital Management LLC* (supra) highlights several points pertaining to financial corporations. Furman Selz Capital Management LLC (Furman) is owned by a single member, ING Furman Selz Asset Management L.L.C, which in turn is owned by ING Financial Holdings Corporation (ING). ING is a financial corporation under California law. In this case, the City of Los Angeles contended that it could impose a business tax on Furman, even though Furman had elected to be disregarded as a separate entity for tax purposes. The City of Los Angeles argued that the in lieu tax provisions are expressly applicable only to bank and financial corporations and that Furman was not a bank or financial corporation. The California Court of Appeals disagreed with The City of Los Angeles. The Court ruled:

*The question presented is whether Furman is entitled to the benefit of the in lieu provisions applicable to financial corporations. A careful reading of the relevant statutes convinces us the Furman is entitled to the benefit of the in lieu provisions of Revenue and Taxation Code section 23182. Pursuant to Revenue and Taxation Code section 23038 and the regulations promulgated thereunder, Furman may elect to be disregarded as an entity for tax purposes. If a limited liability company's separate existence is disregarded for tax purposes, the separate existence of the limited liability company is disregarded for purposes of the Bank and Corporation Tax Law. The in lieu provisions of Revenue and Taxation Code section 23182 are part of the Bank and Corporation Tax Law. If a limited liability company is wholly owned by a financial*

*corporation and elects to have its separate existence disregarded for tax purposes, the limited liability company is treated for tax purposes as a division of its parent financial corporation. . . .*

Because the disregarded entity is treated as a branch or division of its owner, it is properly combined with its single owner to the extent that branch or division is otherwise unitary with the owner's other business activity(ies) or group member(s). *Butler Bros. v. McColgan* (315 U.S. 501) is on point. In *Butler Bros. v. McColgan* (supra), the business activity was carried on by a group of divisions of a single corporation. It involved one corporation, owning as parts of the unitary system, seven different branches in many states.

## **3090 INSTANT UNITY**

Occasionally, the issue is not whether entities are unitary, but when they became unitary. When a corporation acquires another corporation, a period of time often elapses before enough ties are established between the activities to constitute unity. However, business entities can be unitary at the instant that one company acquires ownership of another. For this to occur, the new subsidiary must be integrated with its parent immediately upon acquisition and integration must have been planned or commenced well before the actual acquisition dates. The following SBE decisions illustrate some of the factors that may affect determinations in this area:

In *Appeal of Atlas Hotels, Inc. and Picnic 'n Chicken, Inc.*, 85-SBE-001, January 8, 1985, a taxpayer engaged in a unitary hotel business acquired a corporation that owned and operated a chain of fast food outlets. Immediately upon acquisition, two of the hotel's top executives assumed positions as the two top executives of the fast food company, and began to run the day-to-day operations. Although ten-year employment agreements were signed with several of the top fast food executives as part of the purchase agreement, the duties of these "holdover" managers were restricted and their authority was very limited. Substantive changes to the overall operating philosophy of the fast food chain were immediately instituted, and several service functions were combined for the hotel and fast food operations. Because many of these managerial and operational changes were in the planning stage well before the actual acquisition date, implementation of the changes was commenced immediately upon acquisition. The FTB argued that the integration between the entities was not sufficient to demonstrate unity until the following year when the holdover management was discharged and the intercompany exchanges became more active. The SBE disagreed, and concluded that the activities were unitary immediately upon acquisition.

The *Appeal of The Signal Companies, Inc.*, 90-SBE-003, January 24, 1990, also involved unity with a newly acquired subsidiary. The taxpayer acquired the subsidiary in May 1975. In June 1975, three of the taxpayer's directors were appointed to the subsidiary's board. By July, the taxpayer's directors formed a majority of the subsidiary's directors and had gained control of the most important committees. In October 1975, an executive from the taxpayer's unitary business was elected as president and CEO of the subsidiary. Over the course of the year, the taxpayer and subsidiary exchanged technical and research information on several projects, the taxpayer-controlled board

rejected certain plans that had been made by the former management of the subsidiary and instituted changes, and the subsidiary was included in the central planning being done for the affiliated group.

The taxpayer had included the subsidiary in the combined report from the date of acquisition. Upon audit, the FTB conceded that the subsidiary had become unitary by January 1, 1976, but did not allow combination for 1975. The department argued that the subsidiary was clearly not unitary on the date of acquisition, and the taxpayer had failed to establish a clear date during 1975 when unity was achieved. The SBE agreed that the taxpayer was not immediately unitary upon acquisition, and acknowledged that the ties between the companies were gradually established over a period of several months and that there was no single event or specific date upon which unity occurred. On the other hand, the SBE pointed out that all of the significant integrating factors upon which the FTB based its conclusion that the subsidiary was unitary as of January 1, 1976, were actually in existence by the beginning of the last quarter of 1975. Because the SBE found no basis for distinguishing between the unifying factors existing at January 1, 1976 and October 1, 1975, the SBE concluded that the taxpayer and its newly acquired subsidiary were unitary at least by October 1, 1975.

This case illustrates the importance of determining a date consistent with the unique facts of each case rather than by simply using an arbitrary benchmark.

In *Appeal of Dr Pepper Bottling Co. of Southern California*, 90-SBE-015, December 5, 1990, the taxpayer was a soft drink bottler that was purchased by Dr Pepper Company (DPC), a corporation that manufactured and distributed soft drink concentrates and syrups. The bottler had been a licensee of DPC for many years prior to the acquisition, and over 50 percent of its concentrate and syrup purchases were from DPC.

The taxpayer/bottler did not file its returns on a combined basis with DPC. Upon audit, the FTB determined that the bottler was instantly unitary with DPC as of the date of acquisition. The taxpayer's argument was that there was no difference in the relationship between the two companies before and after the acquisition other than unity of ownership, and unity of ownership, by itself, cannot compel a finding of unity. The SBE rejected this argument, stating that a "vertically integrated enterprise was pre-existing here, needing only unity of ownership to result in a unitary business." Unity was held to have occurred on the date of acquisition.

To determine the point in time when the integration between two activities has developed to the extent that the unitary tests are met, you must determine the changes that have taken place and the dates upon which those changes occurred. The first step in the analysis should be a detailed description of the operations of the new affiliate prior to the date of acquisition. Any pre-acquisition relationships between the entities should be identified and explained in detail. When examining the details of the acquisition, you should note the exact date on which it occurred, and review the purchase agreement and any other agreements related to the acquisition, which may indicate terms and conditions of the sale. In particular, you should be looking for terms that may limit the acquiring corporation's ability to integrate the new company into its operations. For example, some acquisitions may require that existing officers be retained to continue to operate and manage the target corporation.

Once the background information has been obtained, the next step is to describe the changes instituted by the parent at the newly acquired corporation, and the exact date that each change took place. Such changes might include:

- Replacing officers, directors, and key managers of the newly acquired subsidiary with individuals from the parent corporation (or from one of its existing subsidiaries);
- Providing centralized services such as accounting, legal services, pension plans, or computer services to the newly acquired subsidiary;
- Transferring funds through intercompany financing;
- Imposing the parent company's policies and procedures on the newly acquired subsidiary (e.g., requiring a standard chart of accounts, standardized approval procedures for expenditures, etc.); or
- Decisions to discontinue certain product lines, to target new markets, etc.

Suggestions for specific areas to develop and audit techniques to utilize are discussed in MATM 3570 and MATM 3575.

## **3500 GUIDELINES FOR AUDITING UNITY**

Unitary examinations are, by their nature, very fact intensive. You should strive to fully develop the facts and apply the relevant statutes, regulations and case law to the unique set of facts and circumstances of each case. This has several implications for you.

- First, it is essential that you and your supervisor make a judgment call as to whether the potential deficiency or overassessment is material enough to justify the resources needed to adequately develop and support the unity issue. (CCR § 19032(a)(7).)
- Second, you must obtain a good overall understanding of the taxpayer's business before focusing on the details of the unitary relationships. This will enable you to ask relevant questions and make specific information requests.
- Finally, you must prepare your narrative report and Audit Issue Presentation Sheet (AIPS) to present all the facts objectively. The importance of unitary factors may only be put into perspective when viewed in conjunction with the overall activities of the business. Therefore, to prevent the taxpayer from altering the unitary perspective at the protest or appeal level by presenting additional facts that were not considered or rebutted at audit, you must present and explain the complete picture in the AIPS, position letter, and audit report.

## **3505 GENERAL CONDUCT OF THE AUDIT**

## **What Is Evidence**

It is important to distinguish between a fact versus evidence. A fact is an actual and absolute reality as distinguished from mere supposition or opinion. The actual occurrence or existence of a fact is to be determined by evidence.

Evidence in its broadest sense includes anything that is used to determine or demonstrate the truth of an assertion. The California Evidence Code section 140 defines "evidence" to mean the testimony, writings, material objects, or other things presented to the senses that are offered to prove the existence or nonexistence of a fact.

"Writing" means handwriting, typewriting, printing, photostating, photographing, photocopying, transmitting by electronic mail or facsimile, and every other means of recording upon any tangible thing, any form of communication or representation, including letters, words, pictures, sounds, or symbols, or combinations thereof, and any record thereby created, regardless of the manner in which the record has been stored. (California Evidence Code section 250.)

Generally, taxpayers can produce two types of evidence to support their contentions:

- Contemporaneous evidence
- After-the-fact evidence, such as testimonial evidence.

### **Contemporaneous evidence**

Contemporaneous evidence generally refers to documentary evidence that was recorded at or about the time of the facts to which the evidence relates. For example, a press release issued by a taxpayer announcing a merger and touting the anticipated synergistic benefits from the merger would constitute contemporaneous evidence tending to support a finding that the two entities were becoming unitary. At the protest, appeal or litigation level, if the taxpayer produces contemporaneous evidence to support its unitary position, and if the FTB is unable to rebut that evidence, the taxpayer generally will prevail.

Contemporaneous evidence may include but is not limited to:

- Records, documents, reports, ledgers, journals, contracts, and other written material provided by the taxpayer or prepared by an independent third party for the taxpayer.
- Internal office memoranda between key personnel and managers of either the parent or subsidiary. They may show a subsidiary's degree of autonomy from or dependence upon the parent.
- External office memoranda between the key managers of the parent and the subsidiary. Who is making day-to-day operating decisions? Who is making major operating decisions? Who conducts the subsidiary's negotiations with outsiders, and who binds the subsidiary contractually?
- Third-party written communications regarding the subsidiary's transactions with outsiders.

Contemporaneous evidence will either corroborate the taxpayer's story or document the FTB's side of the story. General requests for "correspondence that pertains to the relationship between the parent and subsidiary" may create an opportunity for a taxpayer to provide you only the documents the taxpayer chooses to disclose. You should become familiar enough with the taxpayer's business to be able to request specific documentation. For example, you should identify the potential strong central managers or key individuals of the parent, or autonomous officers of the subsidiary, and should review their business correspondence files. You can use the information obtained from the correspondence files to develop specific interview questions for that individual or for others with whom that manager corresponded.

Documentation and data runs created in response to audit requests is not contemporaneous, and should be carefully analyzed to make sure the documentation is based upon or consistent with contemporaneous documentation or objective facts.

### **Testimonial evidence**

While testimony is often useful in resolving unity issues, contemporaneous documentary evidence provides the foundation for a successful unitary determination. Key personnel of the taxpayer, by testimony, may state certain matters to be as they believe them to be. This becomes the "story" of the taxpayer. However, unless the FTB can offer another side of the story that is supported by documentation, the taxpayer's "story" will be controlling on the issue of unity.

A significant part of the evidence is likely to be testimonial. To reach the proper unitary determination, we must sort through and determine whether the taxpayer's story is correct or whether there is another side to the story. The best chance for discovering the other side to the story is at the audit level. Therefore, you must try to anticipate the arguments or testimony that the taxpayer is likely to make so that the documentation necessary to overcome the testimony will be in the audit file.

## **3515 WHEN IS DOCUMENTATION SUFFICIENT**

At what point have you accumulated enough information to support an audit adjustment involving unity? The answer to this question differs in each case, but the general guideline is that you should develop enough facts to have a clear understanding of the relationships between the entities or activities involved. Although you and the taxpayer may interpret the facts differently, there should be agreement on the underlying facts. That is, you should attempt to obtain the taxpayer's agreement as to what the facts really are.

The amount of documentation that is necessary may vary tremendously depending upon the fact pattern. In an extreme example, assume that a subsidiary sells 100 percent of its product to the parent corporation. This is a strong unitary tie and almost always will cause the corporations to be unitary. If you are seeking to combine the entities, it will probably be sufficient to document the intercompany sales, and obtain a general understanding of the taxpayer's business to be comfortable that there are no countervailing facts that might preclude unity.

As another example, assume that a taxpayer publishes different editions of a magazine with the same title in the United States and in a foreign country. Although this fact suggests a unitary relationship, it is not conclusive of unity. You need to develop enough information to have a good understanding of the business operations, managerial relationships, and flows of value that are really taking place (e.g., are the same articles printed in both editions, are there common advertisers, is printing technology shared). If the taxpayer later provides documentation that highlights only the areas where the operations are autonomous, the FTB needs to be able to rebut the taxpayer's arguments with facts that demonstrate that the overall operations are unitary.

Finally, assume that a commonly owned group of corporations is engaged in diverse business operations, and asserts that those operations are unitary because of the presence of strong centralized management coupled with centralized departments. A unitary examination of the group requires in-depth development of the facts concerning managerial relationships and other flows of value that may be very difficult to quantify. This is one of the most difficult and time-consuming types of unitary examination.

When presenting the facts in the audit narrative or the AIPS, you should avoid using generalizations and labels such as "common purchasing" or "centralized accounting." Instead, you should describe in detail the manner in which the functions are integrated, the extent of the centralization, the benefits derived by the integration, and the significance of the unitary tie in relation to the overall operations. This point is discussed in more detail in MATM 3040. In addition to describing the centralized or integrated functions, you should also describe the functions that each entity or business segment performs for itself, and explain how these functions impact or co-exist with any alleged centralization for the same or similar functions.

You should state the facts as they exist, without distortion. Do not overemphasize unimportant facts in the audit narrative or the AIPS. Do not leave relevant facts out of the narrative report or AIPS merely because they seem to weaken the case you are making for unity or nonunity. There is a perception that developing these facts is the responsibility of the taxpayer rather than you. The reality, however, is that facts that support the taxpayer's position will invariably be brought up at the protest or appeal level, and at that point they may be given greater or less emphasis than they deserve. Therefore, you are responsible for getting – and presenting – all the relevant facts in the audit file.

## **3520 HOW MUCH DOCUMENTATION IS NECESSARY IF THE CASE IS AGREED**

Occasionally, taxpayers will agree to an adjustment to their method of filing before the factual development has been completed. It is difficult to expect taxpayers to undergo the inconvenience and expense of a detailed unitary audit after they have already agreed to the adjustment. On the other hand, there have been instances where taxpayers have protested cases after expressing their "agreement" to you. At the protest or appeal level, it may be difficult for the department to sustain these cases if the factual development is incomplete. To protect the state's interests while minimizing

the inconvenience to the taxpayer, unitary adjustments resulting in a deficiency which are supported by incomplete factual development may only be made if the taxpayer provides a written statement with the following components:

- The taxpayer's agreement to the adjustment, and
- An acknowledgement that if the taxpayer files a protest or a claim for refund, the case will be returned to you so that you may fully develop the unitary facts.

The taxpayer's officer or authorized representative should sign the statement.

You are responsible for obtaining the appropriate amount of preliminary information prior to accepting such an agreement. Use your discretion to determine the amount of preliminary information required.

**(See MATM 2800 and Exhibit K).**

## **3525      RECORDING THE PAPER TRAIL**

The volume of information pertinent to these audits dictates that detailed workpaper files be kept, and that the information be clearly indexed and cross-referenced. Interview questions and Information Document Requests (IDR) should be cross-referenced to responses so that the reader can follow the actions that you have taken. You must summarize and fully cross-reference the audit file. Guidelines for setting up the audit package and cross-referencing files are discussed in MATM 2490 and MAP 6.13.5.

*Include in the audit file copies of all documentation relevant to your determination. In some cases, however, the documentation is too voluminous to be easily copied. In such situations (and only if you do not feel that the information is important to the case), write a memo to the file. In the event that it becomes necessary to request the actual document at the protest, appeal or litigation level, your memo should include:*

- A description of the document, including the name or title of the document.
- The date it was issued.
- The number of pages.
- A description of the contents.
- The name and title/position of the person to contact regarding the document, and where it is maintained.
- A detailed description of the relevant information from the document and a list of the applicable page numbers.

In addition, obtain a photocopy of the title page of the document for the audit file.



Occasionally, taxpayers will allow you to look at documents in their offices but will refuse to allow you to photocopy the documents (or to provide you with photocopies). By law, you are entitled to photocopy documents. (R&TC section 19504, CCR section 19032(b)(5)(D), and the California Court of Appeal decision in *Franchise Tax Board v. Firestone Tire and Rubber* (1983) 139 Cal.App.3d 843.) If you are unable to obtain cooperation, you and your supervisor should contact the Technical Resource Section for assistance.

## **3530 PARTIAL RESPONSES AND DEMANDS FOR INFORMATION**

Occasionally, you will encounter taxpayers who will give you partial responses, give you empty promises, or simply not respond to your IDRs. You must then decide whether it is appropriate to issue a demand letter or whether it would be better to wait for a further response. This is often a difficult decision because of the conflicting goals of:

- Maintaining a good working relationship with the taxpayer,
- Maintaining control of the audit, and
- Striving to complete the audit within a reasonable time frame.

In most cases, however, you should recognize that if the taxpayer is providing incomplete information, not responding to your IDR, or giving you empty promises (e.g., claiming the information is being gathered and will be produced when it becomes available, which never seems to occur), there is not a good working relationship to start with. It is usually better to document and monitor lack of cooperation as soon as it is suspected, so that the taxpayer is immediately aware that you will not accept such practices.

You should recognize that uncooperative behavior may sometimes be more subtle than an express refusal to provide information. Taxpayer's representatives will sometimes attempt to control the progress of an audit by engaging in behaviors such as:

- Being vague about setting a time for the inspection of books and records;
- Allowing only limited access or a trickling disclosure to records;
- Dumping large amounts of unorganized or irrelevant information on the auditor;
- Absence of qualified personnel from the taxpayer's offices at the time of set appointments;
- Absence of certain books and records due to their alleged necessity in other parts of the taxpayer's operation;
- Limiting hours of inspection by late morning appointments, long lunch hours, and early closings;
- Refusing to supply primary sources of information, and insisting you accept something less than primary information (such as documentation created long after the fact, and testimonial evidence);
- Attempting to dictate to you the records pertinent to the audit; or
- Attempting to dominate you with claims that the requests for information are irrelevant, immaterial and inapplicable to the audit.

It is very important that you confront the taxpayer's representative as soon as possible with detailed evidence of the lack of progress. The actions of the representative that impaired the progress of the audit should also be memorialized in the audit file, in a letter to the taxpayer with a copy to the representative, and by the re-issuance of the IDR with a history of the request.

If you are planning an out-of-town trip to review taxpayer records and have doubts about the taxpayer's production of requested documents, you should ask the taxpayer whether they intend to supply the documents before you make the trip. In this manner, you may be able to save time wasted on a trip for which no documents are provided.

You should make every effort to obtain the information necessary to conduct the audit and to support your conclusions and recommendations. In most instances, your written requests for information (IDRs) should contain only a single question or address only a single issue. You should clearly communicate to the taxpayer the need and relevance of the information you are requesting. If the specific information requested does not exist or is overly burdensome for the taxpayer to provide, you should ask the taxpayer if alternative documents exist which will provide the substantiation you need. Your information requests must establish the time frames within which the information is to be furnished. When requested information is not provided or is unreasonably delayed, you should reevaluate the relevance and need for the information before issuing a demand letter:

- Is the request reasonable?
- Has the information already been provided in an acceptable alternative form?
- Is the information necessary to decide the issue?
- Is the taxpayer's failure to provide the requested information due to reasonable cause?

In order to support this type of audit, it is critical that the file contains a good record to support the fact that the taxpayer was uncooperative. The audit file should document the reasons why the information requested from the taxpayer was necessary for a proper audit determination. Since the rationale for asking particular questions may not be obvious several years later as the case is protested, appealed or litigated, this explanation will prevent the taxpayer from successfully arguing that the questions were unreasonable.

The unsatisfied aspects of each information document request should be regularly monitored so that timely demands or subpoenas can be issued. The fact that a taxpayer has provided some of the information requested in an IDR does not preclude the department from issuing demand letters and ultimately a failure to furnish penalty with respect to the remaining information. For example, if a taxpayer is given an IDR requesting five items, and only items 2, 4 and 5 are provided, the auditor may issue a demand for items 1 and 3. Without this audit trail, subpoenas are unlikely to be issued, and the failure to furnish penalty will be difficult to support.

The use of single-question or single-issue IDRs is one method for issuing IDRs that will help to avoid receiving partial responses. Wherever possible the auditor should limit requests for specific documents to one per IDR. Similarly, requests for information or narrative-type responses should be limited to one question or one group of issue-related questions. In the event that the IDR requests are unanswered, use of the single question or single issue format will allow you to send follow-up

requests for each unanswered IDR. Separate IDRs make it easier to document the history of a request (e.g., date of the original request, follow-up dates, extensions granted, etc.) in the event that you recommend a failure to furnish information penalty be assessed.

Foreign parent situations create special problems, and these are covered in MATM 3535. Taxpayers who question FTB's authority to demand information should be referred to [R&TC §19504](#) (FTB's power to examine records) and the California Court of Appeal decision in *Franchise Tax Board v. Firestone Tire and Rubber* (1983) 139 Cal.App.3d 843, which upholds a trial court order enforcing an FTB subpoena and confirms that auditors have the right to photocopy information. If the taxpayer continues to be uncooperative after you have issued a demand letter, you and your supervisor should contact the Technical Resource Section for assistance.

In material cases, options for dealing with uncooperative taxpayers include administrative subpoenas duces tecum (see Subpoena Duces Tecum Audit Guidelines), and the penalties imposed under R&TC § 25112 (water's-edge taxpayers), R&TC § 19141.6 (both water's-edge and worldwide taxpayers), and R&TC §19133 (the generally applicable failure to furnish information upon demand penalty).

The department's policy for issuing demand letters and failure to furnish information penalties is stated in MAP 6.

## **3535 FAILURE TO FURNISH INFORMATION-FOREIGN PARENT AND AFFILIATE SITUATIONS**

In the *Appeal of BSR USA, Ltd.* 96-SBE-009, April 11, 1996, the State Board of Equalization upheld the imposition of the failure to furnish information penalty against a foreign-owned taxpayer, concluding that the taxpayer had not shown reasonable cause for its failure. The SBE held the foreign-owned taxpayer to the same reasonable cause standard to which any other taxpayer would be held: the taxpayer must prove that it acted in the same manner as an ordinary, intelligent, and prudent business person would have acted under similar circumstances. In that case, the taxpayer's actions had clearly established a pattern of "delay and misdirection." In less extreme cases, the extent to which FTB can enforce the penalty against taxpayers when information is under the control of uncooperative foreign parents is still untested. When contemplating failure to furnish information penalties in foreign parent situations, there are certain factors that you need to consider in addition to the normal guidelines and procedures set forth in MAP 6.

When setting a reasonable response time, you should consider the fact that the taxpayer may need to obtain translations if the data is in a foreign language.

If the requested information is not required to be collected or maintained by any U.S. or California record keeping requirement as provided in R&TC section 19141.6, then there may be reasonable cause for failing to provide the information if the taxpayer can demonstrate that:

- The data does not exist,
- The data has been discarded in the normal course of business, or
- The data is otherwise not available due to circumstances beyond the control of the entity that possessed the information.

You should request the record retention policies and indexes to verify the taxpayer's contentions. This guideline applies to all taxpayers, not just those with foreign parents.

California follows the federal policy that reasonable cause is not shown by the fact that the law of the foreign parent's country may impose civil or criminal penalties for disclosure of the information. (See IRC section 982(b)(2.) and the Committee Reports on P.L. 101-239 [OBRA 1989] in regard to the reporting requirements of IRC section 6038A.) Nevertheless, the department's position will be stronger if the purpose for the foreign law is commercial rather than for reasons of national security. Therefore, if the taxpayer brings up foreign law as a reason for not providing information, you should document the foreign law asserted by the taxpayer, try to determine its purpose, and identify whether the nature of the potential penalty is civil or criminal.

You should ask the taxpayer to provide evidence of its attempts to obtain the information from the uncooperative foreign parent, as well as the foreign parent's responses to those attempts. This will not necessarily excuse the failure to provide information, but may give you a more complete picture to evaluate for purposes of determining whether a penalty is appropriate. If possible, a written statement of the reason the foreign parent will not provide the information should be obtained. If the objection has to do with the costs of compliance, the potential inaccuracy that will result from not obtaining the information should be weighed against the costs of compliance. If the lack of information relates to an item with minor tax consequences, then no penalty should be imposed. On the other hand, if no valid reasons are given for the failure to provide information, then the penalty should be considered (but see the next item regarding taxpayers that are minor subsidiaries).

If the officers of the subsidiary are also officers of the parent corporation, then those individuals should be able to obtain the information.

You should look for indications that the taxpayer is able to obtain information from its foreign parent when it suits its needs in the course of its business or in litigation. This may be detected through the corporate minutes or through a Lexis/Nexis or Internet search. Such information may impact the credibility of a taxpayer's argument that it is unable to obtain the information you requested.

If the foreign parent does not want its subsidiary to have the information, you should have the taxpayer ask its parent to provide the information directly to the Franchise Tax Board. You may prepare a letter for the taxpayer to forward to the parent that explains that any information provided during the audit is confidential. (In this type of situation, the audit file should clearly identify the sensitive nature of the information.)

In cases where the above procedures have been exhausted, you and your supervisor may consider the possibility of issuing an administrative subpoena duces tecum. See Subpoena Duces Tecum Guidelines for procedures for issuing an administrative subpoena duces tecum. Note that the

issuance of a subpoena duces tecum does not diminish the department's authority to issue the penalty for failure to furnish information.

If the taxpayer questions the FTB's authority for issuing a failure to furnish information penalty with respect to information that is in the hands of a foreign parent, it may be helpful to refer to R&TC § 19504 (FTB's power to examine records) and to explain that foreign parents who choose to operate in California cannot use subsidiaries to shield themselves from the responsibility of providing unitary information. The California Court of Appeal has recognized that foreign-based unitary groups must furnish the same kind of information as domestic-based groups, and reasonable costs of complying with a particular jurisdiction's taxation scheme are costs inherent in doing business in foreign lands (*Barclays Bank International Ltd. v. FTB* (1992) 10 Cal.App.4th 1742, *affirmed* (1994) 512 U.S. 298).

## **3540 SCOPING PROCEDURES**

A unitary examination begins with the scoping process. As discussed in MATM 2400 - MATM 2445, you can gather a great deal of information during the pre-audit stage by:

- Reviewing the information provided with the return (e.g., federal Schedule M-3, schedules, and attachments).
- Reviewing public documents such as annual reports and Security and Exchange Commission filings (e.g., Form 10-K, Form 20-F, Form 8-K, Schedules 14A and 14C)
- Searching databanks such as Lexis/Nexis for articles on the taxpayer or taxpayer's own Internet website.

Prepare test checks based upon your initial impressions formed during this process (MATM 2530). If the materiality of the issue warrants further investigation, the public documents may contain leads for areas in which to focus the examination.

## **3545 UNDERSTAND THE TAXPAYER'S METHOD OF FILING**

It is important that you understand how the taxpayer filed, and what its basis was for that method of filing. Simply asking the taxpayer why it filed as it did, and confirming the response can sometimes resolve potential unitary issues identified during the preaudit phase.

The prior audit report is a good source for historical information. Once you have determined how the taxpayer was reporting or required to report in prior years, any changes in the method of reporting can be easily identified. Information from the taxpayer's prior years can also assist you in planning the amount of time necessary to complete the audit. For example, when you are trying to establish unity for the first time or where the membership of the group has changed, it is likely that much more audit time will be required than would be the case if you merely have to confirm that the unitary facts existing in a prior period are still present, and use those facts as a building block for the current audit.

You should review prior audit reports during the preaudit phase. Suggestions for performing this review are covered in more detail in MATM 2200. Occasionally, the current audit will indicate a unitary determination that is contrary to the department's position in a prior audit. This circumstance is discussed in MATM 3590.

## **3550 EXAMINING UNITY OF OWNERSHIP**

The requirements for unity of ownership are discussed in MATM 3050.

Ownership information should be obtained in any audit of a corporation. Identification of parent and subsidiary corporations is necessary to ascertain whether those entities should be included in the combined report. Even if an individual or a nonunitary corporation holds the stock of the corporation, you need to identify whether that individual or corporation owns other corporations that may be combinable with the taxpayer.

Both the Federal Form 1120 and the California Forms 100 and 100W require that the taxpayer indicate whether the same interests hold more than 50 percent of its voting stock. The SEC Forms 10-K are required to contain an exhibit listing all significant subsidiaries of the filing corporation. This listing will usually identify whether the taxpayer owns more than 50 percent of the subsidiaries. Corporate directories such as Lexis/Nexis will also contain such lists.

The Federal Form 851 (Affiliations Schedule) lists the 80 percent-owned domestic subsidiaries and should identify whether any changes in stock ownership occurred during the year.

The Federal Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) identifies items such as the foreign corporation's ownership percentage, the country of incorporation, and principal business activity.

Additional techniques for identifying related corporations are also discussed in the sections of this manual describing the income reconciliation (MATM 5130) and the pre-audit procedures (MATM 2000 et seq.).

Wholly owned and closely held corporations keep records regarding the ownership of their stock. If control issues arise with respect to a corporation with a SEC filing requirement, the SEC Form 8-K (and other SEC forms) may contain information that will be useful in determining whether unity of ownership is present. Whenever a change occurs in the control of a corporation registered with the SEC, a Form 8-K is required to be filed to report the details of the transaction and the basis for the control.

Corporations may have several classes of stock with differing voting rights. In such cases, you will need to analyze the relative voting power of each class of stock in order to determine whether common control exists.

### **Example 1**

A corporation has two classes of stock; one of which has 10 voting rights per share and the other 1 voting right per share. Although an individual might not own over 50 percent of the stock, that individual could control the corporation by controlling over 50 percent of the voting rights.

### **Example 2**

Corporation N has two classes of stock. Holders of Class A stock are entitled to elect just two of five members of the board of directors. Holders of Class B stock are entitled to elect the remaining three of the five directors. Individual X holds 500 shares of Class A stock, and unrelated individual Y holds 300 shares of Class B stock. No other shares are issued. Although X owns more than 50 percent of the stock, X cannot control the operations of Corporation N through election of the board of directors. The ownership requirement is therefore not met with respect to individual X.

The articles of incorporation will identify the various classes of stock. Since additional classes of stock may have been authorized after the original incorporation, any amendments to the articles should also be reviewed.

The corporate minute books may contain information regarding transfers of voting power or other factors that will affect the control of the corporation. If you suspect that such agreements exist the details of the transaction will generally have to be obtained from the shareholders rather than from the corporation.

## **3555 SEQUENCE OF UNITARY FACTUAL DEVELOPMENT**

Factual development begins with becoming familiar with the taxpayer's business activities and operations (MATM 3560). Once you have this foundational knowledge of the taxpayer, it is possible to target specific areas for more in-depth examination, and to develop specific requests for documentation that will form the basis for a unitary determination (MATM 3570, MATM 3575). You may use comprehensive written questionnaires and interviews to confirm or expand on the information that you have accumulated (MATM 3580). The questionnaires or interviews may also explore areas that were not adequately covered by other documents. Approaching the audit in this sequence will usually result in the most efficient use of resources.

## **3560 UNDERSTAND THE TAXPAYER'S OPERATIONS**

One of the first steps you should take in any audit is to become familiar with the taxpayer's operations. This involves asking questions such as:

- What do these companies do?

- Where each manufacturing or other operation facility is located?
- What are the products and entities involved?
- Is there more than one business segment?
- Is the business organized in a divisional or multicorporate structure?
- What are the products produced or otherwise processed and/or regular services rendered by each division/business segment?
- What are the activities of each entity?
- What is involved in the major operations?
- What are the major operational decisions?
- Who are the key managers?

As you obtain this information, you should be thinking about the similarities or differences between the operations of the entities (or divisions), and the aspects of the operations where unitary ties might be expected to be present. An analysis of the background information should provide leads to follow in the unitary examination, and should enable you to develop specific information requests that are tailored to the taxpayer's operations.

The initial interview with the tax department personnel is a good place for you to start becoming familiar with the taxpayer's business (suggestions for conducting this interview are in MATM 2802). Since the tax manager may not be knowledgeable about the operations of the various entities, it will probably also be necessary to interview personnel that are involved in the operational side of the business.

Much of the background information can also be derived from organizational charts, the company's public website, annual reports, SEC filings, company profiles, prior audit reports, magazine and newspaper articles (both about the corporations and about the key officers), and company publications and manuals.

As part of this audit step, you should document the ownership and operational structure for the file. You should list the following information for each entity:

- The primary activities and products of the entity.
- The location of the entity's operations.
- The percentage of ownership and voting control.
- Whether the entity has been recently acquired.
- Whether the taxpayer included the entity in the combined report.
- The names and positions of the directors and principal corporate officers. If the officers/directors changed during the audit period, this list should be prepared for each audit year. (If there is a large group of subsidiaries, you may choose to present this information only with respect to the principal subsidiaries.) To aid a reader in interpreting this information, you may also prepare a summary highlighting the common officers and directors.

An ownership chart is very helpful for the file, particularly if it is a complex, tiered ownership structure. Charts showing the divisional structure and/or reporting lines of authority are also very useful.



## 3570 GENERAL SOURCES OF INFORMATION FOR DETERMINING MANAGEMENT INVOLVEMENT AND OTHER UNITARY DATA

The degree of management involvement is a very subjective factor, and the development of facts necessary to establish the degree of management involvement is very resource intensive. A general understanding of the business, as discussed in MATM 3560, is the starting point for evaluating strong centralized management. Once this has been accomplished, you may examine the following sources for indications of the management activity that took place. By piecing together the individual fragments, you can determine the level of management involvement. After you examine the documentation, interviews of key officers generally will be necessary to tie together the pieces and to expand upon your findings.

**Consolidated CPA Workpapers:** CPA firms maintain audit files that could be of significant help in the development of unitary data. Since much of this information is also helpful for income and factor verification, you should review these files early in the audit. CPA workpaper files contain:

- Index: Each file will contain a master index that discloses what is contained in the file. The workpapers are numbered and cross-referenced.
- Consolidation files: The intercompany account analysis contained in the workpaper files may provide data important to a unitary analysis. The consolidation files will also be used for conducting the income reconciliation discussed in MATM 5130.
- Tax accrual files: The tax accrual workpapers are sensitive and need only be requested in rare circumstances.
- Administrative file: This file might be called the Permanent File or some other name depending upon the CPA firm. This file should include an overview of how the corporation is structured. There may also be an analysis of corporate minutes and extracts of significant comments, or a notation if no minutes exist.
- Management comment letters. (These are not required, but may be present.)
- Financial statements by entity: These statements are generally prepared in-house and provided to the CPA firm as a starting point for its audit. This is a good source for by-entity information. You should work off of the final statement that will reflect all closing adjustments, but you should be sure to take into account any adjustments made during the CPA audit.
- SEC, Regulatory and Government filings.
- Foreign Audits: Generally, information on foreign operations will also be in the files of the CPA firm. If a foreign CPA firm has performed the audit on subsidiaries, copies of its work will be in the files of the firm which signs the audited financial statements.
- Tax Return Workpapers: Workpapers used to prepare the tax return may be separate from the financial workpapers. Specific workpapers on Schedule M-1 or Schedule M-3 items should be obtained for the M-1 or M-3 analysis (MATM 5140).

One approach for reviewing this information is to request that the taxpayer contact the CPA firm and arrange for you to visit the CPA firm to review the files. This will maximize the information that can be reviewed. You might receive resistance to obtaining the CPA workpaper files, but we are entitled to them. (*U.S., et al. v. Arthur Anderson & Co.* (1980) 46 AFTR 2d 80-5285, 623 F2d 725, 80-2 USTC Par. 9515.)

**Corporate Minutes of Shareholders, Board of Directors, and all Committees and Subcommittees Thereof:** The minutes may reveal why major corporate actions have been taken, and why the organization is structured the way that it is. Centralized functions may be commented upon. The discussions of major policy decisions and the reports of segment managers may be helpful in ascertaining whether centralized management exists. Statements contained in the minutes will become building blocks for follow-up questions used in interviews of officers.

In addition to minutes of Shareholder and Board of Directors meetings, you should review minutes of Committee and Sub-committee meetings. If the minutes are not very detailed, the agendas and materials that are sent to the directors in connection with the meetings may be helpful.

**Business Plans and Agenda:** Business plans and agendas provide insight into the degree of involvement of centralized management. Business plans may include strategic plans, budget plans, long-term plans, and mission and values statements.

**Employee Communications:** In addition to information about general business operations, employee communications might be helpful in ascertaining the existence of employee transfers and management involvement in the various operations. You should review:

- Bulletin announcements
- Employee newsletters
- Company orientation material/historical publications

**Correspondence Files:** Correspondence files of key officers or managers should help determine the degree of management involvement in the various business segments. Because of the volume and sensitivity of this information, avoid making broad requests for correspondence files. Instead, you should request the entire correspondence files of specific individuals for relevant time periods.

**Manuals:** Manuals can provide information on the degree of centralized functions, common practices, and management involvement. A specific list of all manuals should be requested to insure that all manuals have been identified. When reviewing manuals, you should request the version that was in effect for the years under audit. If that version is not available, you should look at manuals for other years (for example, the current version) and ask the taxpayer to confirm or document whether the specific procedures relied upon from those manuals were in effect during the audit years.

Some types of manuals which taxpayers may have include:

- Policy and Procedure Manuals (these may include retention file requirements -- see MATM 3575)
- Operating manuals such as:
  - Advertising
  - Accounting
  - Marketing
- Forms Manual
- Internal Audit Manual such as an Employee Handbook

**Diaries, Calendars, Travel Expense Analysis:** Diaries and calendars of executives are useful in determining their involvement in the management of the various business segments. In addition, travel expense claims can help establish the location of travel and the purpose of the trips. Time reports might also be maintained to establish the amount of time that was spent on the various business segments. Airline manifests for company aircraft may also be helpful in this area.

**Duty Statements (Job Descriptions) of Key Officers and Management Personnel:** Duty statements will reveal the scope of authority and the responsibilities of the various officers. Some corporations may use employment agreements that will contain this information.

**Court Actions:** Various court actions involving the taxpayer could provide information regarding the operations or about the inner workings of the company. You may find some of this information in the annual reports, SEC filings (e.g., Forms 10-K and 8-K), and by searching in Lexis/Nexis. You may ask key officers or managers whether they have been deposed as to facts about company operations. If the answer is yes, you should take the following steps:

- Review transcripts of testimony
- Review depositions
- Determine the nature of actions taken

Deposition transcripts or exhibits are not subject to the attorney-client privilege and generally are subject to disclosure.

**Speeches:** Speeches given by executives at conferences, stockholder meetings or other business gatherings provide valuable insight into company operations. Through the interviewing process, inquiries may be made to help determine what speeches were given. Some of the areas that you should explore include:

- Transcripts of shareholder meetings. Transcripts of the meeting might contain more information than the Shareholder Minutes themselves.
- Newspaper articles and interviews.
- Inquire as to business conventions attended and determining whether speeches were presented.
- Employee newsletters.
- Videotapes shown to employees.
- Conference agendas.

**Conference Materials, Press Releases, Testimony Before Congressional Committees or Regulatory Agencies:** These sources might be helpful in understanding the interactions between companies and involvement of management. You might identify the existence of such information through a Lexis/Nexis search.

**Internal Audit Reports:** Internal audit reports can be a very helpful source of information. Reports issued to management will set forth the level of compliance with established company policy and procedures. You may obtain the following information:

- Internal audit reports along with the report to management.
- Size of the internal audit department. (The greater the size in relation to the business, the more likely greater internal controls will exist.)
- Internal audit manuals and procedures.
- Scope of duty of the internal audit department.
- Reports other than internal audit reports, if any, generated by internal audit and their significance.

**Electronic Mail:** Electronic mail is a significant means of communication. You should:

- Establish whether electronic mail is retained by data processing.
- Determine which personnel have authorized access.
- Determine levels of authorized access by officers and key managers.
- Determine what hard copies are available.

**Telephone Directory/Calls Made:** An examination of the telephone directory provides insight into overall company communications. A review of specific telephone bills for officers and key management personnel can be of significant help in determining the amount of contact between organizations. You might wish to:

- Obtain a company directory for years under audit
- Review telephone bills
- Obtain information on faxes and telexes

**Capital Expenditure Authorization:** Capital expenditure authorizations help determine the degree of centralized management. The policy and procedures manual should be reviewed to determine the levels of authorization and the approval procedures for capital expenditures. You should document the approval limits at the subsidiary or divisional levels.

**Visitor Logs:** An examination of visitor logs might be of assistance in determining which officers and key management personnel visited a particular entity. Although useful, such information is not necessarily complete because permanent passes might be held by many key personnel who are not required to sign the visitor log. You can:

- Determine dates visits were made.
- Determine who made the visits and use this data to check travel expense claims for establishing the purpose of the visit.
- Determine who had been issued permanent passes and would not have signed in on visitor logs.

**Management Fee Allocation Workpapers:** Management fee allocations can be used for determining centralized management involvement. You should:

- Identify the amount of charges made to the specific subsidiary.

- Analyze the charges to determine the components of the management fee.
- Determine how the management fee is calculated.

**Regulatory Reports:** Regulatory reports required to be filed with various federal and state agencies can provide extensive information as to the background and operations of the company as well as financial information that will be useful for examining income, apportionment factors and other issues. In addition to SEC filings, some types of regulatory reports are specific to an industry (for example, banks are regulated by the FDIC, the Comptroller of the Currency and state banking agencies; electric companies are regulated by the Public Utilities Commission; airlines are regulated by the Federal Aviation Administration). Other reports are required when a corporation takes certain actions. (For example, when large corporations are involved in mergers or acquisitions, they may file extensive information with the Federal Trade Commission pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Information provided by such filing includes details of intercompany sales, product lines, locations of factories, a description of the acquisition, and studies, surveys, analysis and reports prepared for the purpose of evaluating the acquisition.)

## **3575 SUGGESTED AREAS OF UNITARY DEVELOPMENT**

In addition to management involvement (discussed in MATM 3570), the following suggested areas of development might be applicable to large corporations. Not all of this information will be necessary (or relevant) in every audit. On the other hand, many taxpayers may have documentation or unitary features that are not covered by this list. This list is intended only as a guide for you to tailor to the specific circumstances of your audit.

It is important that you understand the record retention practices of the organization. Most large organizations have a retention file listing the records that are retained, and the location of those records. This can be valuable for identifying documents that will aid in the factual development. Unitary relationships are not always uniform throughout an affiliated group. Therefore, when developing facts involving multiple entities, it is important to identify which facts apply to which entities. For example, if a parent corporation provides a centralized service, you should document which entities used that service, and to what extent.

### **Intercompany Sales and Services**

To determine the amount of intercompany sales and services, you should:

- Review the intercompany accounts in the detail general ledger to determine the items which are being charged to those accounts.
- Identify the significance of the items that are sold intercompany (e.g., are they essential components of the purchasing company's product, can they be obtained from other sources).
- For both the selling company and the purchasing company, list both the amounts of intercompany sales (purchases) for each year, and the percentage that those amounts bear to total sales (purchases). (This information will also be useful in verifying the sales factor -- see MATM 7518.)

- Take a "big picture" look at the intercompany transactions occurring between all members of the group. Transactions that might seem minor when taken in isolation may be significant when viewed in conjunction with other transactions.

### **Technical Service or Licensing Agreements**

Whether or not agreements have any unitary significance depends upon their importance to the business of the corporations involved. In order to understand the significance of such agreements, you should develop information such as the following:

- Percentage of licensee's sales that is based on the license.
- Purpose for the stock ownership of the licensee (e.g., a pre-condition for the agreement).
- Other indicia of an operational relationship such as the number of visits from the licensor to the licensee or vice versa, the level and amount of product review and exchange of a technical/marketing information, and whether the two companies have common directors and common officers making operational decisions for the licensee.

### **Personnel Transfers/Hiring/Human Resources**

The movement of personnel between corporations is one element of unity, as is the use of common human resources ("HR") departments. In order to understand the process and determine the records that should be reviewed, interviews with HR Managers may need to be conducted. Based upon the information developed, you should:

- Interview HR managers and determine the extent to which HR resources are shared.
- Review employee newsletters for hiring and transfer disclosures.
- Develop employment dates, positions and employment history of officers and key management individuals (sometimes this information is summarized in annual reports or SEC Forms 10-K).
- For transfers within the audit period, determine the old and new position and corporation.
- Obtain the total number of employees and compare to the number of transfers to determine significance.
- Evaluate the personnel level and classification of the transfers to determine the level of training and expertise that is being transferred along with the employee.

### **Research and Development**

Common research and development (R&D) can be an important element of unity. Before developing this element, it is important that you have an understanding of the operations, as well as the products and processes that are involved. An interview with the R&D manager is a good first step in developing this area. You should:

- Determine licensing arrangements between parent and subsidiaries, obtaining copies of the agreements and understanding the essential terms of the agreement.
- Obtain a list of issued patents and pending patents and determine whether these are being used within the group.

- Determine whether R&D departments exist at subsidiary levels and determine their functions.
- Determine the R&D expenditures by entity.
- Determine how R&D is funded.
- Determine what technical information is exchanged between the R&D departments and all the entities.

## **Marketing**

Marketing of company products is a very significant element of unity. You should:

- Interview the marketing manager to determine how the operation functions.
- Determine whether there are central distribution facilities.
- Determine how the channels of distribution function.
- Obtain master customer lists and identify significant common customers.
- Determine whether common logos and trademarks are being used.
- Determine whether there are common procedures for customer relations, discounts, etc.
- Determine whether there is a common sales staff.
- Determine who generates sales literature, catalogs, etc.
- Determine if there is a central toll free number for placing orders for parent and subsidiary products.
- Determine who authorizes and accepts returns.
- Determine how pricing strategies are determined.
- Examine major marketing contracts.
- Examine the sales commission structure to determine whether, e.g., the parent's sales force is compensated for sales of subsidiaries' products.

## **Centralized Purchasing**

Centralized purchasing of major raw materials is a significant item, while the purchasing of more incidental items such as office supplies, rental cars or employee group discounts carries much less importance in a unitary context. You should:

- Determine whether a centralized purchasing department exists.
- If the business segments use similar materials, but no centralized purchasing department is evident, supplier lists may be requested to determine whether common suppliers are used. For smaller operations, purchase invoices may be sampled to obtain this information.
- If centralized purchasing or common suppliers are present, determine whether volume discounts result.
- Determine whether centralized purchasing is operational (raw materials) or incidental (office supplies).
- Determine the types of national purchase contracts that exist.
- Determine whether purchasing is required from an approved list of vendors.
- Review policy manuals for requirements relating to purchasing.
- Review purchase order requirements.
- Determine who negotiates the terms for purchasing.

## **Intercompany Financing**

Remember that intercompany financing used to further diverse businesses is not a significant item unless that financing serves to further a unitary cause (see MATM 3040). The detail general ledger can be reviewed to identify intercompany loan accounts. The loan files and the company's policy for intercompany financing may then be inspected to determine additional information. Items of inquiry would include:

- Determine amounts advanced and repaid during year.
- Identify amounts, terms and entities involved in intercompany financing.
- Identify borrowing authorizations and restrictions.
- Identify taxpayer's guarantees of and collateral pledged for debts of another entity.
- Identify guarantors of and collateral pledged for a taxpayer's debt.
- Identify how excess funds are handled.
- Identify uses and sources of funds.

## **Treasury Review**

Many companies maintain treasury policy and procedures manuals, which provide information regarding the treasury function. The manager of the treasury department may also be interviewed to determine how the treasury function is operated. Information that you should obtain includes:

- Determine how the cash management program functions.
- Determine the types of financial reports that are generated.
- Determine reporting controls on divisions and subsidiaries.
- Determine the independent borrowing capacity of divisions or subsidiaries.
- Determine how letters of credit are obtained and what collateral is pledged.
- Determine how credit is extended to major customers and who has the responsibility for this function.

## **Physical Facility Use**

Sharing of common facilities is an element of unity. Steps to develop this item include:

- Obtain a directory/location of corporate facilities.
- Review facility use plans and determine who performs this function.
- Determine whether there is a centralized real estate department, and what its functions are.
- Determine which facilities are commonly used.
- Determine who has the function of approving real estate leases.

## **Employee Benefits**

Employee benefits is an element of unity. You should:



- Obtain an employee handbook, which explains benefits.
- Determine which benefits are common throughout the organization.
- Determine which benefits are not common throughout the organization.
- Determine whether profit sharing exists and if so, how it is determined.
- Determine whether stock bonus plans are paid with stock of the parent or subsidiary.

## **Advertising**

Common advertising is an element of unity. You should:

- Interview the advertising manager and determine how the operation functions.
- Determine if there is a centralized advertising department.
- Determine whether there is any assistance, advice, direction, or coordination among business segments regarding advertising.
- Determine whether advertising is done on an international, national, or local basis. To the extent that advertising is not uniform throughout the markets served by the affiliated group, are there similarities as to advertising format, target market, common advertising agency, use of logos/trademarks, etc.? Sample advertisements or advertising contracts from different geographic areas may be used to obtain this information.
- Obtain copies of advertisements from different business segments to determine whether they stress the identity of (or affiliation with) the corporate parent, or simply indicate the subsidiary's identity.
- Obtain product brochures to determine whether uniform trademarks, trade names, service marks or logos are used.
- Contrast subsidiary advertising cost with parent cost.

## **Accounting**

Depending upon the nature of the activity, accounting may be a significant item if centralized bookkeeping types of services are provided. Items pertaining to the preparation of audited financial statements or consolidated federal tax returns are common to all investments and would not be a significant item. In order to evaluate this area, you should:

- Interview the controller or accounting manager to determine what operations are centralized.
- Identify the records that are created.
- Review the Accounting Procedures Manuals.
- Determine the standard forms that are utilized.
- Determine reporting requirements of subsidiaries.
- Determine collection procedures and establish who performs this function.

## **Insurance Review**

Insurance is an element of unity. You should:

- Interview the risk assessment/insurance and loss control manager to determine the workings of the insurance department.
- Determine common coverage.
- Determine separate coverage.
- Determine whether a centralized insurance department exists.
- Determine whether the company is self-insured.
- Document the savings from common coverage. Letters from the insurance agent to the company may set forth such savings.

## **Legal Department Review**

Legal services are elements of unity. You should:

- Determine whether a centralized legal department exists.
- Determine the number of legal staff at the corporate level.
- Determine the number of legal staff at the operating level.
- Determine the degree to which outside counsel is used and for what items.
- Determine the operational role played by in-house legal staff.
- Ascertain benefits involved in using in-house versus outside counsel. In addition to cost savings, benefits may take the form of specialized knowledge or expertise regarding the company's legal environment.
- Review the in-house billing invoices to determine the types of services that were provided and how those services were billed.

## **Labor Relations**

Labor relations can be a factor in making a unitary determination. You should:

- Interview the labor relation's manager and determine the department's function.
- Determine who negotiates union contracts.
- Determine if there is a centralized department dealing with labor relations such as Equal Employment Opportunity Commission (EEOC).
- Determine how employee grievances are handled.
- Review employee personnel and hiring procedures and determine whether this function is centralized.

## **Management Information Systems (Computers)**

Management Information Systems (MIS) provide a significant amount of computerized information for the organization. You should explore this area:

- Interview the MIS manager.
- Determine what the MIS system is and what reports are generated.
- Determine whether there is a central data processing center. (If there is more than one computer facility, identify the services that are provided at each location.)

- Determine whether there is a central programming staff.
- Determine whether there is a central software development center.
- Determine whose tasks/projects are performed by the data processing center.
- Determine how requests are referred to MIS.
- Explore how hardware requirements are determined.
- If subsidiaries maintain their own computer facilities, identify the services provided by those facilities. Explain the extent to which each of the subsidiary computer facilities is tied in with the parent's (or another subsidiary's) computer system to receive or exchange particular data.

## **Training**

Corporations may provide training to their employees through either training programs (such as management development or sales training) or manuals (for example, a training manual on internal accounting procedures). To develop this issue, you must first determine what types of training programs or manuals the corporations use. You must then develop the following information:

- Obtain a list of training courses given.
- Determine the nature of the training (management or technical).
- Determine which personnel classifications attend the training.
- Determine which subsidiaries send personnel to the training (or use the manuals).
- Obtain names and history of the training staff.
- Determine whether a centralized training facility exists.

## **Other State Audits**

You may request the unitary audit results from other states. (See MAP 6.11.) Although not controlling, such information might be useful in deciding whether supplied facts are consistent from state to state.

## **3580 INTERVIEWING KEY EMPLOYEES**

An important technique for developing information about a corporation's management and operational structure is to interview key employees. Tax managers frequently will not know the answers to questions about the various functions of the organization. Since the answer to one question will often generate other questions, written questionnaires can in many cases be an inefficient way to develop the information.

Since tax managers may be reluctant to allow you to go outside the tax department for information, you may have to be insistent about interviewing employees. Tax managers generally have the responsibility for maintaining control over the audit. However, they should not be allowed to maintain control over the type or source of information necessary for resolving the audit. You should explain to the tax manager why the interviews are necessary, and should be flexible to minimize the

inconvenience to the taxpayer. For example, it may be necessary for you to travel to a subsidiary's location to interview an employee that does not work at the headquarters office. Alternatively, you may consider scheduling a telephone interview or a video teleconference.

To examine many of the key operational functions (see MATM 3575), it is necessary for you to gain an understanding first of how the function is performed, and what types of documents or reports are available. This information is usually most efficiently obtained through an interview with the manager in charge of the function. For example, the development of facts concerning the research and development function might start with an interview of the R&D manager. You should prepare for the interview by compiling a list of general questions such as:

- What type of research is performed?
- What are the applications of that research to the various products produced by the group of corporations?
- What products or processes have been developed and what patents have been obtained?
- Which entities have directly benefited from the research?
- Is all the research performed at one location or is there more than one research facility?
- What are the channels for a subsidiary to request a specific type of research project?
- What are the channels for research developments to be shared with the operating entities?
- How are the subsidiaries charged for R&D?
- What types of reports are generated by the R&D department?

The responses to these general questions will undoubtedly lead to additional, more detailed questions.

Sometimes, interviews will be held after the initial fact-gathering process is complete rather than as a preliminary step in the factual development. The purpose of these types of interviews is to tie together and expand upon the facts that you have obtained, or to resolve apparent conflicts in information that have developed. Interviews of key officers to determine the presence of strong centralized management will fall into this category. The types of questions asked in these interviews are based upon your analysis of the documents that have previously been obtained. Since you will be asking the interviewee to comment specifically on the documentation, you should prepare carefully for the interview and may consider presenting the interviewee with examples of the items upon which they will be asked to comment.

Generally, the persons to be interviewed in connection with an evaluation of strong central management should be in charge of the companies under examination, be a common manager, or have knowledge concerning a potentially common department. Questions to ask someone from a potentially central department should address the nature of the services provided to the various entities in question. Other questions for potentially central managers could include:

- What is the interviewee's background, work experience, where do they fall in to the chain of command?
- What is the person's area of responsibility and how is it performed in conjunction with other managers?

- How are differences and disagreements resolved between entities (examples should be requested)?
- What are examples of major accomplishments or major decisions that cut across corporate entities?
- What types of decisions made by the subsidiary were overridden by the parent?
- Any other questions that will determine if the manager had a regular, operational role in the affairs of a subsidiary.

If you receive conflicting information during the audit, you should ask the interviewee to resolve it.

Some techniques for conducting successful interviews are as follows:

Prior to the interview, you should:

- Obtain function descriptions and job descriptions of the relevant areas to determine who should be interviewed.
- When selecting individuals to interview, ask if they were in their present position during the audit years. If the current manager of a department was not involved with that department during the audit years, it may be preferable to interview a former manager or another employee who is knowledgeable about that department's operation during the relevant time period.
- Whenever possible, schedule interviews in the morning and leave the afternoon free to write up the summary of the interview while the conversation is still fresh in your mind. If you must interview two people on the same day, schedule the interviews so that there will be ample time in between to expand or clarify your notes.
- Ask the taxpayer if the interview can be recorded. This will enable you to concentrate on the interview rather than on note taking. Most taxpayers will not object to the recording as long as they receive a copy of the tape.
- Consider scheduling a tour of the facilities relating to the job function prior to the actual interview. By obtaining a general understanding of the function, specific questions can be framed, and the responses can be placed into perspective.

During the interview, you should:

- At the beginning of the interview, emphasize that the responses should reflect the facts as they existed during the audit years. It may be necessary to remind the interviewee of this focus during the conversation.
- Obtain the names of relevant documents and reports so that you can later confirm the interviewee's statements.
- Ask whether you may contact the interviewee directly to ask any follow-up questions. Some taxpayers prefer that such inquiries be first directed to the tax manager.

After the interview, you should:

- As soon as possible, prepare a summary of the interview from your notes or from the tape recording. The summary of the interview should identify the name, position and area of responsibility of the person interviewed. To establish the credibility of the responses, it is also a good idea to record the length of time that the individuals have been in their present position, and any other positions that they held with the company.
- Ask the interviewee to sign the summary after reviewing it for accuracy. This will prevent misunderstandings from arising over what was said.
- Request documentation to confirm important information obtained orally during the interview. If any of the documentation conflicts with the information obtained during the interview, ask the interviewee to explain the discrepancy.

## **3590 CHANGE IN POSITION FROM PRIOR YEARS AUDIT**

Occasionally, your current audit findings will indicate a determination that will be contrary to the position taken by the department in an audit of prior years. The interpretation of a taxpayer's unitary facts should be applied consistently from year to year. Consequently, a change in position from the prior audit is not a decision that should be taken lightly. On the other hand, there are circumstances where such a change is appropriate.

A taxpayer's method of filing is sometimes either allowed or adjusted by auditors based upon insufficient evidence (such as when an audit is closed as a result of a taxpayer's failure to furnish information or when an NPA is issued due to an impending SOL). In other cases, the prior audit determination may have been based upon theories that have been invalidated by the SBE or courts (for example, many audits completed in the past denied combination based solely upon the lack of functional integration). If the current audits of these taxpayers indicate the taxpayer's method of filing to be improper, you should make the necessary changes to place the taxpayer on the correct method of filing.

It is also possible that the facts have changed from the prior audit and this will clearly indicate a need to change the method of filing. You must document these changes in detail within the audit report. It is very important to note the dates that significant events occurred.

Most of these cases are not black or white situations. Before you make a change in the filing method, a thorough discussion of the facts should be held between you and your supervisor.

## **3595 HOW TO PROCEED AFTER A REFUND IS DETECTED**

**If the taxpayer has not been contacted**

Before commencing the audit, you will perform a test check to determine if a combination or decombination of a group of taxpayers will result in a refund (see MATM 2530). If the unitary issue is likely to produce a refund but you are not certain that the issue will be resolved in the taxpayer's favor, then you may still continue with the audit of other items in the tax return if the tax potential of those items is materially greater than the potential refund. If the decision is made to pursue the audit, the taxpayer must be notified that the potential for a refund exists from the unitary issue and that the taxpayer has the burden of developing the unitary facts and figures if it so chooses a specific time frame should be established for a reply.

### **If the taxpayer has been contacted**

There are occasions when the potential for a refund is not detected until the taxpayer has been contacted. Since one of the department's primary responsibilities is to perform audits on an equitable basis, the taxpayer must be notified that preliminary audit work uncovered the possibility of a refund. The taxpayer should be informed that if it wishes to pursue the refund, it has the responsibility of developing the unitary facts.

If the known facts clearly indicate that a refund would result from correcting the taxpayer's method of filing but the taxpayer for whatever reason expresses no interest in pursuing the refund, then the other audit issues generally should not be adjusted unless the tax potential of those issues is materially greater than the potential refund. Even if you are certain that a unitary relationship exists, it is not necessary to develop the taxpayer's refund if substantial effort will be required to put together the necessary numbers. Any unadjusted issues should be disclosed in the narrative for follow-up in the event the taxpayer subsequently decides to file a claim for refund.