



STATE OF MICHIGAN  
DEPARTMENT OF TREASURY  
LANSING

RICK SNYDER  
GOVERNOR

ANDY DILLON  
STATE TREASURER

## REVENUE ADMINISTRATIVE BULLETIN 2013-1

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### CORPORATE INCOME TAX UNITARY BUSINESS GROUP CONTROL TEST AND RELATIONSHIP TESTS

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

#### RAB 2013-1

Under the Corporate Income Tax (“CIT”), a unitary business group (“UBG”) is two or more qualifying United States persons that satisfy both a *control test* and one of two alternate *relationship tests*.<sup>1</sup> A unitary business group is a single taxpayer under the CIT and must file a combined return.<sup>2</sup> Foreign persons and foreign operating entities cannot be included in a unitary business group.<sup>3</sup>

This Revenue Administrative Bulletin (“RAB”) describes the *control test* and the two alternative *relationship tests* described in MCL 206.611(6). If a group of entities satisfies the control test as described in the statute, and if that same group also satisfies one of two relationship tests described herein, that group of entities will constitute a UBG.

#### ISSUES

- I. How is a unitary business group defined under the CIT?
- II. What is the control test under the CIT?
- III. What are controlled groups of entities?
- IV. How do voting agreements affect the control test?

<sup>1</sup> MCL 206.611(6)

<sup>2</sup> MCL 206.611(5), 206.691

<sup>3</sup> *In re Estate of Wheeler*, 297 Mich App 411; \_\_\_ NW2d \_\_\_ (2012), held that for purposes of Part 1 of the Income Tax Act, there is no water’s edge limitation on apportionment of business income. This holding is not applicable to the Corporate Income Tax which expressly prohibits a foreign entity from being a member of a unitary business group.

- V. How is control determined for nonstock nonprofit organizations?
- VI. How is a unitary business group determined if one entity is a member of more than one controlled groups of entities?
- VII. What is “indirect” ownership?
- VIII. What are the relationship tests under the CIT?
- IX. What special considerations exist in applying the relationship tests?
- X. What factors should be weighed in determining whether either relationship test is met?

## CONCLUSIONS

### I. UNITARY BUSINESS GROUP DEFINED

Under the CIT, a UBG is defined as:

a group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other members, and that has business activities or operations which result in a flow of value between or among members included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other.<sup>4</sup>

A corporation is a person that is required or has elected to file as a C corporation as defined under section 1361(a)(2) and section 7701(a)(3) of the internal revenue code. A corporation does not include an insurance company or a financial institution.<sup>5</sup> A group must meet both a control test and one of two alternative relationship tests before that group will be a UBG.

### II. CONTROL TEST DEFINED

The control test is satisfied when one person owns or controls, directly or indirectly, more than 50% of the ownership interests with voting or comparable rights of the other person or persons.

A person owns or controls more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of another person if that person owns or controls, directly or indirectly, (1) more than 50% of the total combined voting power of all ownership interests with voting (or comparable) rights *or* (2) more than 50% of the total value of all ownership interests with voting (or comparable) rights. “Ownership interest with voting rights” includes all classes of stock in a corporation entitled to vote that possess the power to

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<sup>4</sup> MCL 206.611(6).

<sup>5</sup> MCL 206.605(1).

elect the membership of the board of directors of the corporation. “Ownership interests that confer comparable rights to voting rights” includes instruments, contracts, agreements, or other authority demonstrating an ownership interest in that entity that confers power in the owner to vote in the selection of the management of that entity.

**Example 1.** Corporation A owns 5 shares of class A stock and 10 shares of class B stock in Corporation X. Corporation B owns 40 shares of class B stock in Corporation X. Corporation C owns 50 shares of preferred stock in Corporation X. Each class A share has 10 votes per share of stock owned. The class B shares have 1 vote per share of stock. The preferred shares have no voting rights. Corporation A owns 60% of the total voting rights of Corporation X and satisfies the control test.

### III. CONTROLLED GROUPS OF ENTITIES

A person owns or controls more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of another person if that person owns or controls (1) more than 50% of the total combined voting power of all ownership interests with voting (or comparable) rights *or* (2) more than 50% of the total value of all ownership interests with voting (or comparable) rights. Entities that satisfy the CIT control test constitute “controlled groups of entities.” Controlled groups of entities are described below.

**(A) Parent-Subsidiary Controlled Group of Entities.** A parent-subsidiary controlled group of entities satisfies the control test. A parent-subsidiary controlled group of entities means any group of one or more chains of entities connected through ownership with a common parent if (1) the common parent directly or indirectly owns more than 50% of the ownership interests with voting or comparable rights of at least one other entity, and (2) more than 50% of the ownership interests with voting or comparable rights of each entity other than the common parent is owned directly or indirectly by one or more of the other entities.

**Example 2.** Corporation A owns 51% of Corporation B, which owns 51% of Corporation C, which owns 51% of Corporation D. The common parent owns more than 50% of the stock in at least one other entity (Corporation B), and more than 50% of the stock of each entity other than the common parent is owned by at least one other entity in the chain. Corporations A, B, C, and D are part of a parent-subsidiary controlled group of entities and satisfy the control test for unitary business groups.

**Example 3.** Same facts as Example 2, except that Corporation C is a foreign person. Corporations A, B, and D are part of a parent-subsidiary controlled group of persons and satisfy the control test for unitary business groups. Corporation C, as an intervening foreign person, is still used to determine ownership and control, but is excluded from the unitary business group because it is not a United States person as required under MCL 206.611.

**Example 4.** Corporation A owns 51% of Corporation B, which owns 51% of Partnership 1. Partnership 1 owns 51% of Corporation C. Corporations A, B, and C are part of a parent-subsidiary controlled group of persons and satisfy the

control test for unitary business groups. Partnership 1 is still used to determine ownership and control even if it is excluded from the UBG.

**(B) Brother-Sister Controlled Group of Entities.** A brother-sister controlled group of entities may also satisfy the control test. A brother-sister controlled group of entities means two or more entities connected through common ownership where one such entity indirectly owns more than 50% of the ownership interests with voting or comparable rights of one or more of the other sibling entities.

**Example 5.** An individual owns 51% each of a pair of companies taxed as C corporations – Corp One and Corp Two. Due to indirect ownership, discussed at Section VII of this RAB, Corp One indirectly owns 51% of Corp Two, and *vice versa*. Corp One and Corp Two constitute a brother-sister controlled group of entities and meet the control test for UBGs.

**Example 6.** Two unrelated individuals each own 50% of Corporation H and Corporation I. Corporation H indirectly owns 100% of Corporation I, and *vice versa*. Corporation H and Corporation I constitute a brother-sister controlled group of entities and meet the control test for UBGs.

**Example 7.** ForeignCo, a foreign corporation, owns 100% of Corporation Q and Corporation R, both U.S. corporations. As a foreign person, ForeignCo cannot be a member of a UBG. However, Corporation Q is the indirect owner – through ForeignCo – of 100% of Corporation R, and *vice versa*. Corporation Q and Corporation R meet the control test for UBGs.

**(C) Combined Controlled Group of Entities.** A combined controlled group of entities satisfies the control test. A combined controlled group of entities means three or more entities each of which is a member of a parent-subsidiary controlled group of entities or brother-sister controlled group of entities and one of which is a common parent entity of a parent-subsidiary controlled group of entities and also is included in a brother-sister controlled group of entities.

**Example 8.** An individual owns 51% each of a pair of corporations – Corporations L and M. Corporation L owns 51% of Corporation N, which owns 51% of Corporation O. Corporation L is the common parent of the L, N, and O parent-subsidiary controlled group of entities and is also a member of the L and M brother-sister controlled group of entities. Corporations L, M, N, and O are members of a combined controlled group of entities and meet the control test for UBGs.

**(D) Excluded Ownership Interests.** For purposes of determining ownership or control under the control test, the Michigan Department of Treasury (the “Department”) will apply IRC 1563(c), other than IRC 1563(c)(2)(B), to exclude certain ownership interests from determination of ownership and control, except that the Department will apply IRC 1563(c) to all forms of ownership interests and not just corporate stock.

**Example 9.** Corporation X owns 50% of Partnership Y. The remainder of Partnership Y is owned by an individual who is also a principal stockholder under

IRC 1563(c) of Corporation X. Partnership Y owns 51% of Corporation Z. The individual's ownership interest in Partnership Y is treated as an excluded ownership interest under IRC 1563(c) as applied to the CIT. For purposes of the control test for UBGs, Corporation X owns 100% of Partnership Y and 51% of Corporation Z.

**(E) Controlled Group of Entities Without Common Control.** In certain circumstances, the attribution rules of Section VII of this RAB may result in a controlled group of entities that are not in fact under the control of a member of the controlled group or under common control of any person. A controlled group of entities such as this may fail to satisfy control standards for unitary businesses generally described by U.S. Supreme Court precedent. In most of these cases, the controlled group of entities in question would fail the relationship test under MCL 206.611(6). However, if it is determined – despite satisfying the control test as described in this RAB and the relationship test under MCL 206.611(6) – that the members of the controlled group of entities are not under common control of a person (including a member of the purported controlled group) or group of related persons, then that controlled group of entities will not satisfy the control test for purposes of MCL 206.611(6). One or more persons within the purported controlled group may nonetheless comprise one or more controlled groups of entities or may be required to file separate returns.

#### **IV. VOTING AGREEMENTS**

For purposes of this RAB, in determining whether the ownership interests owned by a person possess voting (or comparable) rights, the Department presumes the following, subject to rebuttal by the taxpayer:

- (1) Unless noted otherwise below, ownership interests will be considered as possessing the voting rights accorded to such interests by statute, organization documents filed with the state, by-laws, certificates, agreements, or other authority.
- (2) If there is any agreement that an owner will not vote his or her interests in an entity, the formal voting rights possessed by his or her interests will be disregarded in determining the percentage of ownership interests with voting rights owned by the other owners of the entity.
- (3) If there is any agreement that an owner will vote his or her ownership interests in the manner specified by another owner of the entity, the ownership interests with voting rights owned by the first owner will be considered to be owned by the other owner.
- (4) If an owner transfers voting power by proxy, voting trust, agreement, or similar device, and that transfer is revocable by the transferor, then the transferor shall be considered to be the owner of any ownership interest with voting rights otherwise transferred.

However, if there is any evidence of an implied or oral agreement or concerted action between or amongst owners or other persons, the Department will examine all of the facts and circumstances in determining whether the ownership interests owned by a person or persons possess voting (or comparable) rights.

## V. NONSTOCK NONPROFIT ORGANIZATIONS

For entities without stock or other forms of ownership interests, such as nonstock nonprofit organizations, a parent entity controls more than 50% of the ownership interests with voting or comparable rights if more than 50% of the directors or trustees of that organization are either representatives of or controlled by the parent organization.

## VI. ENTITY IN MORE THAN ONE CONTROLLED GROUP OF ENTITIES

If, under this RAB, an entity is a member of more than one controlled group of entities, the entity shall be treated as a member of the controlled group with respect to which it satisfies the relationship test under MCL 206.611(6). If the entity satisfies the relationship test with more than one of those groups, it shall elect to be treated as a member of only one of the controlled groups in question. This election shall remain in effect until the unitary relationship between the entity and the rest of the members of its elected controlled group is discontinued, or until revoked with the approval of the Department.

Similarly, if the application of this RAB results in a group of entities that comprise two or more overlapping controlled group of entities, but not one single controlled group of entities, the UBG shall be that controlled group of entities that satisfies the relationship test under MCL 206.611(6). If more than one controlled group of entities satisfies the relationship test, the members shall elect the controlled group of entities that will file as a UBG. This election shall remain in effect until the unitary relationship between the entity and its elected controlled group is discontinued, or until revoked with the approval of the Department.

**Example 10.** Individual A owns a 75% capital interest in Corporations X and Y, and 50% of the stock in Corporations L and M. The remaining 50% of L and M are owned by individuals B and C respectively. Individuals A, B, and C are unrelated. Under this RAB (including the indirect ownership principles discussed in Section VII), X, Y, and L comprise a brother-sister controlled group of entities. X, Y, and M also comprise a brother-sister controlled group of entities. However, X, Y, M, and L do not comprise a single controlled group of entities (since either L or M is the indirect owner of X and Y, but neither L nor M owns the other). The unitary business group in this case will be that controlled group of entities that satisfies the relationship test. If both controlled groups of entities satisfy the relationship test, then the members must elect one of such controlled groups of entities to file as a unitary business group.

## VII. INDIRECT OWNERSHIP

Under MCL 206.611, ownership and control includes indirect ownership and control. Indirect ownership includes ownership through attribution. Except as noted below, an ownership interest is indirectly owned by a person when that person constructively owns such an interest.

(A) **Family.** An individual constructively owns the ownership interests owned, directly or indirectly, by any of the following:

- (1) His or her spouse (other than a spouse who is legally separated from the individual under a decree of divorce or a decree of separate maintenance).
- (2) His or her children (including legally adopted children), and grandchildren.
- (3) His or her parents.

**Example 11.** Brother owns 100% of Corporation B. Brother's sibling, Sister, owns 100% of Corporation S. Brother and Sister's parents are both living. Under (A)(2), Father or Mother own 100% of both Corporation B and Corporation S. Furthermore, under (C)(2), Corporation B indirectly owns 100% of Corporation S, and *vice versa*. Corporation B and Corporation S constitute a brother-sister controlled group of entities and meet the control test for unitary business groups.

**(B) Attribution from Partnerships, Corporations, and Trusts and Estates.**

(1) **Partnerships.** Ownership interests owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5% or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever is greater.

**Example 12.** Ms. Smith has a 50% capital and profits interest in Partnership X. Partnership X owns 100 shares of Corporation Y. Under B(1), Ms. Smith indirectly owns 50 shares of Corporation Y.

(2) **Corporations.** If 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the ownership interests owned, directly or indirectly, by or for such corporation, in that proportion to which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

**Example 13.** Mr. Smith owns 75% of the value of the stock of Corporation E. Corporation E owns 1000 shares of Corporation F. Under B(2), Mr. Smith indirectly owns 750 shares of Corporation F.

(3) **Trusts and Estates.**

(a) Ownership interests owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary who has an actuarial interest of 5% or more in such ownership interests, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such ownership interests to satisfy his rights as a beneficiary.

(b) Ownership interests owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of

subchapter J of the IRC (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.<sup>6</sup>

(c) This paragraph shall not apply to ownership interests owned by any employees' trust described in IRC 401(a) that is exempt from federal income tax under IRC 501(a).

**(C) Attribution to Partnerships, Corporations, and Trusts and Estates.**

(1) **Partnerships.** Ownership interests owned, directly or indirectly, by or for a partner shall be considered as owned by the partnership.

**Example 14.** Ms. Jones is a partner in Partnership X. Ms. Jones owns 500 shares of Corporation Z. Under C(1), Partnership X indirectly owns 500 shares of Corporation Z.

(2) **Corporations.** If 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the ownership interests owned, directly or indirectly, by or for such person.

**Example 15.** Mr. Jones owns 50% of the value of the stock of Corporation Q. Mr. Jones owns 200 shares of Corporation R. Under C(2), Corporation Q indirectly owns 200 shares of Corporation R.

(3) **Trusts and Estates.**

(a) Ownership interests owned, directly or indirectly, by or for a beneficiary of an estate shall be considered as owned by the estate.

(b) Ownership interests owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in IRC 401(a) and exempt from federal income tax under IRC 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this subsection, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5% or less of the value of the trust property.

(c) Ownership interests owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J of the IRC (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.<sup>7</sup>

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<sup>6</sup> Generally, IRC 671-679.

<sup>7</sup> Generally, IRC 671-679.



**(D) Options.** If any person has an option to acquire any ownership interest in an organization, such interest shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such interest.

**(E) Operating Principles.**

(1) **In General.** Except as provided in subparagraphs (2) and (3) below, ownership interests constructively owned by a person by reason of the application of paragraphs (A), (B), (C), or (D) above, shall, for purposes of applying paragraphs (A), (B), (C), or (D), be considered as actually owned by such person.

(2) **Members of Family.** Ownership interests constructively owned by an individual by reason of the application of paragraph (A) shall not be considered as owned by him for purposes of again applying paragraph (A) in order to make another the constructive owner of such ownership interests.

(3) **Partnerships, Corporations, and Trusts and Estates.** Ownership interests constructively owned by a partnership, corporation, estate, or trust by reason of the application of paragraph (C) shall not be considered as owned by it for purposes of applying paragraph (B) in order to make another the constructive owner of such ownership interests.

(4) **Precedence of Option Principle.** For purposes of this paragraph, if an ownership interest may be considered as owned by a person under paragraph (A) or (D); it shall be considered as owned under paragraph (D).

(5) **Ownership by 2 or More Persons.** If an ownership interest is owned by two or more persons, such an interest shall be considered as owned by the person whose ownership of such an interest results in the entity being a member of a controlled group of entities.

(6) **S Corporations.** For purposes of this Section VII, an S Corporation shall be treated as a partnership and any shareholder of the S Corporation shall be treated as a partner of such partnership.

### **VIII. THE TWO ALTERNATIVE RELATIONSHIP TESTS**

The definition of a UBG, in addition to satisfying the control test, requires that the group of persons have business activities or operations that:

- (1) Result in a flow of value between or among persons in the group, **or**
- (2) Are integrated with, dependent upon, or contribute to each other.

A taxpayer need only meet one of the two alternative tests to satisfy the relationship test.

**(A) Flow of Value Test.** The United States Supreme Court described a unitary business as a functionally integrated enterprise whose parts are mutually interdependent such that there is a flow of value between them.<sup>8</sup> There must exist “some sharing or exchange of value not capable of precise identification or measurement-beyond the mere flow of funds arising out of a passive investment. . . .”<sup>9</sup> In determining whether a flow of value exists, a relevant question in the inquiry is whether contributions to income resulted from “functional integration,” “centralization of management,” and “economies of scale.”<sup>10</sup> No one fact is determinative of whether functional integration, centralization of management or economies of scale exist. Rather, the statutory test requires that the totality of facts and circumstances surrounding the business activities and operations be weighed and examined for cumulative effect.

(1) **Functional Integration.** Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operations of the entities. This may include but is not restricted to the transfer or pooling of products or services, shared technical information, marketing information, purchasing, distribution systems and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, or processes. There is no requirement that a specific type of functional integration exist.

Both horizontal integration and vertical integration may use types of functional integration. Horizontal integration is typified by entities that are engaged in similar business activities or processes, such as two fertilizer plants, or a chain of retail stores. These entities may be functionally integrated when, for example, they share common marketing, purchasing or distribution systems. Vertical integration applies when various entities each engage in a different step in a structurally coordinated enterprise. An example of vertical integration is a group of entities where one entity mines ore; that raw ore is supplied to another entity that smelts and refines the ore; and a third entity fabricates the refined ore into consumer goods. It is irrelevant that the various steps in the process are operated substantially independent of each other. When the component parts are closely connected to each other, the relationship is functionally integrated and inseparable. When there is functional integration that renders a separation of the different operations unnecessary or impossible, the relationship test is satisfied.

(2) **Centralized Management.** Centralized management entails involvement and oversight by management in the operational decisions of the entities. Directors, officers and other management personnel making decisions that affect the business activities of the entities and that operate to benefit the operations of the group of entities as a whole indicate a centralized management. Centralized management may flow down from parent to subsidiary, up from subsidiary to parent, from one subsidiary to another, or in any combination. The mere decentralization of day-to-day management responsibility and accountability will not preclude a finding that a centralized management exists. When an integrated executive force appears to exist that has control over major policy decisions, this factor is evidence that centralized management exists. Whether centralized management actually exists will be determined by the facts and circumstances unique to each case. The focus is on the role of management of an entity or entities in the affairs of its affiliates, whether the management process is grounded in its own

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<sup>8</sup> *Container Corp of Am v Franchise Bd*, 463 US 159 at 178-179 (1983).

<sup>9</sup> *Id* at 166.

<sup>10</sup> *Id* at 179.

operational expertise and whether the process is applied to the other entities.<sup>11</sup> For example, the business “guidelines” established by a parent for its subsidiaries, the “consensus” by which a parent’s management process was involved in the subsidiaries’ business decisions, and the oversight and other assistance provided by a parent to its subsidiaries all point to centralized management.

(3) **Economies of Scale.** “Economies of scale” is a phrase that refers to a relationship between business activities that result in a significant decrease in the cost of operations or administrative functions for the entities due to an increase in operational size. Economies of scale may result from the presence of functional integration or centralized management. For example, the decision to pool advertising may indicate functional integration and also indicate that a centralized management decision was made resulting in economies of scale. There is no clear delineation between functional integration, centralized management, and economies of scale. One factor may evidence the satisfaction of one or more of the flow of value standards.

(B) **Contribution/Dependency Test.** The alternate “contribution/dependency” relationship test asks whether business activities are integrated with, dependent upon or contribute to each other. Business activities that are dependent upon or that contribute to the income or value of the whole demonstrate operations that are engaged in a unitary business.<sup>12</sup> The focus is on whether one entity’s business activity is dependent on the business activity of another entity or whether the activity of one entity contributes to the activity or operations of another entity. This occurs under many of the same circumstances as the flow of value test. Where the facts indicate that business activities are conducted and managed under one centralized system there is evidence that the entities are dependent upon each other or that they contribute to each other such that the elements of a unitary business group are present.

## IX. SPECIAL APPLICATION CONSIDERATIONS

(A) **Application of Links in a Chain within a Group.** It is not necessary for all entities to have a direct relationship connection with every other entity for a unitary group to exist. It is sufficient if the relationship is indirect. So long as each person in a controlled group has a flow of value, or contributes to, or is integrated with at least one other person within the controlled group, the entire group will have a unitary relationship. All that need be established is that an entity forms an inseparable part of a unitary business group’s business wherever conducted. For example, Corporations X, Y, and Z have an indirect relationship in that Corporation X is a raw material supplier to Corporations Y and Z that are wholly owned subsidiaries of Corporation X. Corporation X produces oil, Corporation Y is a fertilizer manufacturer, and Corporation Z produces tires. Corporation X sells petroleum products to the two subsidiaries for use in their respective manufacturing processes. This relationship allows Corporation X to better estimate production needs and provides a diversified market for its oil production. Corporations Y and Z have no common officers, sales, administrative functions, or technologies that are shared or pooled between them. Corporation X is unitary with Corporation Y and Corporation Z when the facts and circumstances surrounding the relationship between Corporation X and each subsidiary demonstrate a flow of value or contribution and dependency when considered alone. Under the

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<sup>11</sup> *Id* at 180 n 19.

<sup>12</sup> *Edison California Stores v McColgan*, 30 Cal 2d 472; 183 P2d 16 (1947).

“links in the chain” unitary application, the intangible “flows of value” within the group serve to link the entities together as if they were a single entity. The fact that there is no direct flow of value or dependency between the two subsidiaries, Corporations Y and Z, does not preclude the entities from being part of the unitary group. All three corporations are a single unitary business group.

**(B) Instant Unity: Establishment of a Unitary Relationship.** Whether the unitary relationship can arise “instantly” depends on the surrounding facts and circumstances. Instant unity refers to the situation where a new entity is acquired or formed by another entity and the new entity establishes a unitary relationship the instant the entity is formed or the stock or assets are acquired. A unitary relationship may take time to develop when an entity acquires another. This may be so even if the entities are in the same business and are complementary. Many times, the integration of the acquired entity will occur over a period of time and it will continue to operate independently. Such autonomous operation may require a longer period of time for the unitary relationship to develop. In contrast, the acquisition of an entity where there was a pre-existing relationship may support a finding of an instant unitary relationship. For example, if the purchaser had a minority interest and had a presence on the board of directors, or had indirectly influenced operations, or the acquired entity was a supplier of inventory or buyer of products from the purchaser, those facts would be important considerations in determining whether an instant unitary relationship exists.

On the other hand, when a new entity is formed, there may be a financial infusion of capital, the transfer of personnel, transfer of intangibles and knowledge, pooling of expertise, pooled marketing and shared use of established policies, procedures and administrative plans. These factors would tend to support a conclusion that an “instant” unitary relationship exists.

The same relationship tests set out in statute are used for determining if an acquired or newly formed entity is included in the unitary group. There are no legal tests separate from the two standard unitary relationship tests set forth in the statute that are used for determining if instant unity exists. Also, rules governing federal consolidated groups for federal purposes are not dispositive as to whether a unitary business group is formed for CIT purposes. When a federal consolidated group acquires another entity and it becomes part of the federal consolidated group without further election, the acquired entity may not automatically be included in the unitary business group for CIT purposes. The acquired or newly formed entity must still meet the control test and either of the two relationship tests to be included in the CIT unitary business group. There is no specific time requirement that dictates when a person becomes a member of a unitary business group. Whenever both the control test and one of the two relationship tests are met that person must file as a member of the UBG and it remains a member of that group so long as the control test and one of the two relationship tests continue to be met.

As the control test is the more objective of the two unitary group tests, it will often be addressed first. When the control test is met, taxpayers should be prepared to provide explanations of the review conducted to determine that the entities did not meet the relationship test and that they should file separately. If a taxpayer makes a determination that one of the two relationship tests has been met, or has not been met, it must also be able to provide facts and circumstances that support the finding. The taxpayer’s determination, however, may be rebutted by the Department based on the actual facts. If the facts cannot support a finding that one of the two relationship tests has been met for a controlled entity, the taxpayer must indicate the excluded entity on the

Department's form, and state the reason why the entity is not part of the unitary business group even though the control test is met.

## **X. FACTORS DEMONSTRATING A FLOW OF VALUE OR DEPENDENCY**

The following factors may support a finding that functional integration, centralization of management, or economies of scale exist. These factors can also support a finding that the entities are dependent upon, or contribute to the business activities of each other. The following factors are not intended to be all-inclusive; they are intended to provide examples of factors that can support a finding that a UBG exists. Further, the factors discussed are not intended to provide a hierarchy of importance; rather, each factor must be weighed in light of the totality of the facts and circumstances.

Evidence of functional integration may be provided by the following factors:

1. Intercompany sales, exchanges, or transfers of intangibles, services or products between business entities. Sales at fair market value will not prevent a finding of functional integration because intercompany sales can represent a steady market for a seller or source of products for a buyer. The amount of the intercompany sales as a percentage of total sales and the nature of the items sold will reflect the significance of this factor in establishing functional integration. Sales among horizontally or vertically integrated entities are an indication of functional integration.
2. Transfers of technical information, know-how, trade secrets, research and development or other intangibles that are significant to the operations or activities of the entities.
3. The sharing and use of any administration, accounting, payroll, inventory control or distribution systems that are controlled through a common network.
4. Purchases of substantial quantities of goods, services or intangibles significant to the entities' sales or operations, particularly if the purchases result in cost savings.
5. Common marketing that results in mutual advantage. Common marketing is found when the business entities' products are sold to a common customer, the entities use a common trade name or identification; or the entities identify themselves as members of the same enterprise. Common advertising can exist whether it is obtained through an external or internal advertising provider.
6. Common intercompany financing. This may include the pledging of credit or guarantee by one entity for the benefit of another if the financing serves an operational purpose. An example might be the pledging of credit to secure another member's loan that will be used to expand its manufacturing capabilities. Lending for passive investment purposes does not by itself provide evidence of functional integration. The financing practices must contribute to the operational integration of the entities.

Evidence of centralized management exists when common officers or management participate in decision making for the various entities. Management may share knowledge or expertise among the entities. When an integrated executive force appears to exist that has control over major policy decisions, this factor is evidence but not conclusive that centralized management exists. Common officers, directors or management alone does not provide evidence of centralized management. Whether centralized management exists depends on the actual facts and circumstances and whether the control impacts the overall operational strategy of the entities.

Economies of scale may be evidenced by:

1. Centralized purchasing designed to achieve savings through volume, timing of purchases or interchangeability of parts.
2. Centralized administrative functions such as legal services, accounting, payroll, human resources, and employee benefit administration. An entity that achieves cost savings, through affiliation with other entities that it otherwise would not be able to obtain on its own due to size, market, or financial resources, provides evidence of economies of scale.

The fact that a particular factor may provide evidence of functional integration does not mean that it cannot also provide evidence of economies of scale or centralized management and vice versa.

Under the alternate “contribution/dependency” relationship test, businesses are “integrated with, are dependent upon, or contribute to each other” under many of the same circumstances that establish flow of value. However, this alternate relationship test is also commonly satisfied when one entity contributes to the financing of operations of another or when intercompany transactions exist, including operational financing. Intercompany financing and loan guarantees may evidence dependency or contribution. Intercompany sales are indicative of market dependency and the contribution of a market source by one entity to another. Contribution or dependency can also exist through executive policymaking, personnel training, research and other functions.

Other indicators that a unitary business exists include business activities in the same line of business or business activities that are different processes in a vertically integrated business. Examples might include a chain of clothing stores or vertically integrated business activities that include the exploration, extraction and processing of natural resources.

**Examples.** The following examples are not intended to be conclusive as to whether a unitary business exists, but rather are intended to provide examples of factors that could support a finding that a UBG exists. When reviewing the facts and circumstances, the factors identified need to demonstrate a significant interrelationship among the related entities such that the entities are considered to be a single unitary group.

**Example 16.** Corporation A, taxpayer, is one subsidiary of a nationwide group of six wholly owned subsidiaries of P Corporation. The group is involved in the manufacturing, assembly, installation, sale, and resale of widgets. Similar manufacturing processes are used by all the entities and process improvements are implemented at all the operations. P Corporation,

Corporation A, and another wholly owned subsidiary conduct advertising operations for the entire corporate group. Advertising is conducted through the publication of a catalog and price lists. The catalog reveals that each member of the group merchandises virtually identical products.

P Corporation is principally owned by three individuals. All of P Corporation's directors are also directors of at least one of the subsidiaries, and two of P Corporation's directors are directors of all the subsidiaries. In addition, P Corporation's officers are also officers for several of the subsidiaries. Each entity operates autonomously in day-to day operations. All entities follow common practices and policies established by management.

Corporation A acquires approximately an equal amount of its inventory from P Corporation and five other vendors. P Corporation purchases less than one percent of its merchandise from Corporation A. P Corporation however, purchases the majority of the items it later sells from its subsidiaries. Borrowing and financing are arranged by P Corporation for its subsidiaries' cash flow needs. P Corporation signed letters of credit on behalf of three of its subsidiaries for the purchase of depreciable assets. P Corporation also occasionally finances direct purchases of materials used by its subsidiaries. Corporation A has a loan with P Corporation for \$100,000. P Corporation occasionally makes volume discount purchases on behalf of the subsidiaries. The subsidiaries immediately repay P Corporation for the sums advanced for these purchases.

Under this fact pattern, it appears that a significant degree of mutual dependency and contribution exists to conclude that a unitary business exists. The subsidiaries are wholly owned by the Parent. While the entities operate autonomously on a daily basis, an integrated executive force appears to exist that controls major policy decisions demonstrating centralized management. Further, the entities operate similar businesses, use similar manufacturing processes and share know-how among the members of the group. The sharing of know-how and use of similar processes that are significant to the entities' operations indicate functional integration. The decision to implement a common marketing plan through the use of one catalog for identical products results in mutual advantage by reducing marketing costs and achieves economies of scale. This also demonstrates functional integration of the entities as does the lending of money for operational purposes, the purchasing structure and financing arrangements for materials used by the subsidiaries that were entered into by the parent.

The substantial flow of products between the entities also demonstrates a dependency upon each other for mutual economic well-being. The subsidiaries provide the parent with a steady source of inventory and in return are assured of a market for their products. These factors also indicate that an integrated enterprise exists.

**Example 17.** Parent, Corporation A, owns 51 percent of Corporation B. Presume Corporations A and B are unitary. Corporation B owns 100 percent of Corporation C. Corporation A manufactures and sells household products. Corporation B manufactures vitamin products and diet supplements. Corporation C is engaged in the business of molding and manufacturing custom-designed plastic parts and products. Several individuals serve as common officers or directors of Corporations B and C. Five of Corporation C's six directors are concurrently officers of Corporation B, including the executive vice president, secretary, and controller.

The board of directors of Corporation C is responsible for the establishment of its company policy. At the same time, the board determines the annual budget for the corporation and makes major decisions impacting upon the financial resources of the company. In order to keep Corporation B apprised of its current financial condition, Corporation C is required to submit financial reports to Corporation B on a monthly basis. Corporation B is able to further monitor Corporation C's cash flow through its controller who was appointed to Corporation C's board of directors. Last year, Corporation C had a substantial loss. An integrated executive committee comprised of Corporation B and C's management was formed to develop, coordinate, and direct all of Corporation C's administrative, manufacturing, and sales functions. The executive committee also made recommendations on the acquisition of new molding equipment.

In its day-to-day operations, Corporation C functions as an autonomous business. Its employees conduct all of the plastic molding and manufacturing activities. Corporation C does not share facilities or exchange technical information with either Corporation A or B. There are no transfers of personnel between Corporation C and the two parent companies. Nor does Corporation C participate or engage in the centralized purchasing of supplies or in the mutual solicitation of orders. Corporation C directs its own advertising, promotion, and sales campaigns. Accounting, banking, insurance, legal counsel, personnel, administration, employee benefit plans, and research are also independently handled by Corporation C.

Corporation C did not receive any loans from Corporation A. Previously, Corporation B had made loans to Corporation C. Corporation C paid these loans in full with interest by the end of the year. Corporation B charged Corporation C for the costs of providing payroll and financial services. This intercompany charge was discontinued when Corporation C found a vendor to provide the services at a lower cost. Corporation C's tax returns are prepared by the accountants for the parent entities.

Corporation C makes intercompany sales of plastic vitamin bottles to Corporation B and sells other specialized goods used as promotional gifts by both Corporation A and B. The combined intercompany sales represent about a quarter of Corporation C's total sales. Of this amount, the majority of the sales are to Corporation B. In the immediately preceding year, total intercompany sales amounted to 5 percent of total sales.

From this fact pattern, it appears that a unitary relationship exists between Corporations A, B and C. It is not necessary to find a direct unitary relationship between Corporation C's operations and the operations of Corporation A. It is sufficient if the unitary relationship is indirect. If Corporation C has been engaged in a single unitary business with either Corporation A or B, then Corporation C's operations are unitary with the operations of Corporations A and B.<sup>13</sup>

The existence of an integrated executive force at the top level of management is an indication of centralized management. Five of Corporation C's six directors are concurrently officers of Corporation B including the executive vice president, secretary, and controller. Although not involved in the day-to-day operations of Corporation C's plastic molding business, Corporation B appears to exercise executive control of Corporation C. The parent company did more than just offer financial guidance with its executives serving in the top management positions of Corporation C. All six directors on Corporation C's board were currently or had previously been

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<sup>13</sup> See *Appeals of Monsanto, Co*, Cal St Bd of Equal, 70-SBE-038, Nov 6, 1970.



officers or directors of the parent corporations. The secretary and controller were identical for Corporations B and C. The presence of Corporation B's officers on Corporation C's executive staff and board is relevant to show that it is subject to the implicit control of Corporation B so as to render the two corporations an integrated enterprise. The ability of the board to set policy for Corporation C demonstrates executive control by Corporation B at the highest level. The creation of the executive committee and the decisions it made regarding acquisitions, sales and administrative policies further indicate an integrated business.

Not only does Corporation B's controller monitor the subsidiary's financial condition but Corporation C is also required to submit monthly reports and assented to the preparation of its annual tax returns. The executive committee is consulted on the acquisition of new equipment. These facts indicate that the integration of executive members and the centralization of management between Corporation C and its parent have unitary significance. The practice of lending money for operations further indicates functional integration of the entities.

In addition, the substantial flow of products from Corporation C to both parent companies demonstrates that the companies contributed to or were dependent upon each other for their mutual economic well-being. The increase in total sales volume from one year to the next was substantial in the context of Corporation C's total sales figure. The increase in sales between the entities indicates a decision to provide a market for C's products. Further, the increase in sales could be attributed to the decisions of the executive committee comprised of Corporation B and C's management that was formed to develop, coordinate, and direct all of Corporation C's administrative, manufacturing, and sales functions. The fact that these sales might be a small portion of all purchases made by the parent corporations, or that the product flow is one-way or made at market or arms-length prices, does not negate the fact that the intercompany sales are advantageous to Corporation C in that it has a ready and willing buyer for a substantial amount of its production. Intercompany sales allow Corporation C to benefit from the economics of a larger scale operation while guaranteeing the parent corporations have an available source of customized products.

Based on some or all of these factors, Corporation C's business appears to be dependent on and contributes to the activities of both parent corporations to a significant degree. This relationship forms a functionally integrated enterprise between the three companies.

The relationship tests are subjective and all factors present must be reviewed and weighed. Whether a unitary relationship exists will be based on the totality of the facts and circumstances.