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MICHIGAN BUSINESS TAX - UNITARY BUSINESS GROUP 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 2010-2

Under the Michigan Business Tax ("MBT"), a unitary business group is two or more persons that satisfy both a *control test* and one of two *relationship tests*.¹ A unitary business group is a single taxpayer under the MBT and must file a combined return.² Foreign persons and foreign operating entities cannot be included in a unitary business group.

This Revenue Administrative Bulletin ("RAB") describes the alternative *relationship tests* described in MCL 208.1117(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 unitary business group. (See the Department's RAB on the topic of a Unitary Business Group Control Test).

ISSUES

- I. How is a unitary business group defined under the MBT?
- II. What are the relationship tests under the MBT?
- III. What special considerations exist in applying the relationship tests?
- IV. What factors should be weighed in determining whether either relationship test is met?

¹ MCL 208.1117(6)

² MCL 208.1117(5), 208.1511

CONCLUSIONS

I. UNITARY BUSINESS GROUP DEFINED

Under the MBT, a unitary business group is defined as:

. . . a group of United States persons, 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 United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.³

Thus, a group of U.S. persons must meet both a control test and one of two relationship tests before that group will be a unitary business group.

II. THE TWO ALTERNATIVE RELATIONSHIP TESTS

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

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.⁴ 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.⁵ 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."⁶ No one fact is determinative of whether functional integration, centralization of management or economies of scale exist. Rather, the statute requires that the totality of facts and circumstances surrounding the business activities and operations be weighed and examined for cumulative effect.

³ MCL 208.1117(6)

⁴ *Container Corp of Am v Franchise Bd*, 463 US 159 at 178-179; 103 S Ct 2933; 77 LEd2d 545 (1983).

⁵ *Id* at 164-166.

⁶ *Id* at 179.

i. 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.

ii. 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 whether the management role is grounded in its own operational expertise and the control over overall operational strategy for the entities.⁷

iii. 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

⁷ *Id* at 180 n 19.

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.⁸ 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.

III. 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, three 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 "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, Y and Z does not preclude the entities from being part of the unitary group. All three corporations are a single unitary business group.

⁸ *Edison California Stores v McColgan*, 30 Cal 2d 472; 183 P2d 16 (1947).

B. Instant Unity: When a Unitary Relationship is Established

Whether the unitary relationship can arise "instantly" is dependant 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 whenever 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 MBT 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 MBT 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 MBT unitary business group.

As the control test is the more objective of the two unitary group tests, the Department believes 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 entity 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 would support such a 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.

IV. 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, but rather, they are intended to provide examples of factors that can support a finding that a unitary business group 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:

- 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 on the significance of this factor in establishing functional integration. Sales among horizontally or vertically integrated entities are an indication of functional integration.
- 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.
- The sharing and use of any administration, accounting, payroll, inventory control or distribution systems that are controlled through a common network.
- Purchases of substantial quantities of goods, services or intangibles significant to the entities' sales or operations, particularly if the purchases result in cost savings.
- 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.
- 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 is dependent 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:

- Centralized purchasing designed to achieve savings through volume, timing of purchases or interchangeability of parts.
- 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 can not 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 be factors that are evidence of 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 unitary business group 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 1. 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 2. 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 business group 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.⁹

⁹ See *Appeals of Monsanto, Co*, Cal St Bd of Equal, 70-SBE-038, Nov 6, 1970.

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 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 subsidiaries 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 the factors present must be reviewed and weighed. Whether a unitary relationship exists will be based on the totality of the facts and circumstances.