What New York Can Learn From California's Combined Reporting History

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In this A Pinch of SALT, the authors look at California's rich regulatory, administrative, and judicial 50-year history of combined reporting to identify ways in which New York can avoid some of California's pitfalls, learn from California's experience, and improve on its unitary experiences. This article focuses on the cornerstones of unitary combined reporting, including the definition of a unitary business, and on the composition of a unitary group.

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As part of a sweeping law change, New York will require taxpayers to use a water's-edge combined reporting method when filing corporate income tax returns beginning January 1, 2015.

I. Unitary Business Principle

To determine the constitutional limits of who may be in a combined group, the unitary business principle — that is, whether a group of related companies is deemed engaged in one, apportionable business — must be applied. Nearly 40 years before the U.S. Supreme Court announced the modern definition of a unitary business in 1980,[1] California had devoted significant resources (including litigation) to determine the contours of the unitary business principle as applied in the state.[2] California's history of judicial and regulatory authority surrounding the definition of a unitary business can be instructive as New York embarks on its own journey into combined reporting. Further, New York will have the benefit of the U.S. Supreme Court jurisprudence developed during the 1980s, which California did not have the benefit of until much later in its combined reporting journey.

A. California's Unitary Tests

California began its judicial development of the unitary business principle in *Butler Brothers v. McColgan*.[3] In that case, the California Supreme Court addressed whether the income of a taxpayer that had a central purchasing division in Illinois and sales warehouses in multiple states could be apportioned to California using formulary apportionment. The court held that formulary apportionment was permissible if the taxpayer was conducting a unitary business. The court concluded that the unitary nature of the taxpayer's business was established by unity of ownership; unity of operation as evidenced by central purchasing, advertising, accounting, and management divisions; and unity of use in its centralized executive force and general system of operation, thus establishing the three unities test.[4]

California further developed its unitary business concept in 1947 through the creation of the "contribution and dependency" test in *Edison California Stores Inc. v. McColgan*.[5] *Edison* addressed whether the income of separate corporate affiliates could be combined and apportioned to California even though only one of the subsidiaries was

[1]The unitary business principle was developed by the U.S. Supreme Court to test whether a state has exceeded constitutional limits on extraterritorial taxation. *See Mobil Oil Corp. v. Vt.*, 425 U.S. 445 (1980).

[2]*Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983).

[3]17 Cal.2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942).

[4]*Id.* at 341.

[5]30 Cal.2d 472, 183 P.2d 16, 21 (1947).

engaged in business within the state. The court determined that a unitary business exists when "business done within the state is dependent upon or contributes to the operation of the business without the state."[6]

In 1973 California refined the contribution and dependency test when it adopted the Multistate Tax Commission's regulation governing single businesses.[7] Regulation 25120(b) provides:

> The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the divisions under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole.

A unitary business will be presumed to exist if the taxpayer's activities are in the same line of business or are steps in a vertical process, or if the taxpayer exhibits strong centralized management.[8]

B. The U.S. Supreme Court's Test

In 1980 the U.S. Supreme Court issued a seminal decision delineating the constitutional scope of a unitary business for state apportionment purposes. In *Mobil Oil Corp. v. Commissioner of Taxes*,[9] the Court stated that unitary business is characterized by functional integration, centralization of management, and economies of scale.[10] Although the Court has held that there is no single test for determining whether a unitary business exists, it has consistently applied that test — commonly referred to as the *Mobil* three-factor test — since *Mobil* was decided.[11] Thus, in *Exxon Corp. v. Wisconsin Department of Revenue*,[12] the Court applied the three-factor test even though the Wisconsin Supreme Court had applied the contribution and dependency test. Further, in 2008 the U.S. Supreme Court described functional integration, centralized management, and economies of scale as the "hallmarks of a unitary relationship."[13]

C. California's Application of the Unitary Business Tests

California courts have occasionally been divided over whether the three unities test and the contribution and dependency test are alternative tests. In *Superior Oil Co. v. Franchise Tax Board*,[14] the California Supreme Court held that the three unities test was an enumeration of the general contribution and dependency test described in *Edison*, whereas the California Court of Appeal in *A.M. Castle & Co. v. Franchise Tax Board* held that the three unities and contribution and dependency tests were alternative methods for determining unity.[15] The Franchise Tax Board also treated the two tests as alternative tests in FTB Notice No. 92-4 and in its Multistate Audit Technique Manual.[16]

Despite California's focus on the three unities and contributions and dependency tests, in a 1989 notice, the FTB acknowledged that the "*Mobil* statement of what constitutes a unitary business is perceived by many to provide a better analytical framework" for determining the existence of a unitary business.[17] The notice further said that the *Mobil* three-factor test would be the primary standard for the FTB's determination of a unitary business.[18] Yet, when California amended its water's-edge regulation in 1992 to define the term "unitary business," that regulation adopted language providing that a unitary business will exist "if unity of ownership, unity of operation, and unity of use are present, or the activities carried on within the state contribute to or are dependent upon the activities carried on without the state, or if there is a flow of value between the activities."[19] That regulation does not mention the *Mobil* three-factor test.

Similarly, several cases following the 1989 notice have addressed only the three unities test or the contribution and dependency test when analyzing whether a unitary business was present.[20] Also, the FTB's Multistate Audit Technique Manual mentions the *Mobil* three-factor test, but only as a variation on the contribution and dependency test. California's position is perplexing because the U.S. Supreme Court's consistent application of the *Mobil* three-factor test, and its endorsement of that test as providing the "hallmarks of a unitary business," should end any confusion about which test is the dominant one and the best suited to determine the existence of a unitary business.

D. California's Instant Unity Doctrine

Although California has a significant amount of case law and regulatory guidance regarding what constitutes a unitary business, the state's guidance on when taxpayers will be

[6] *Id.* at 21.
[7] *See* Cal. Code Regs. title 18, section 25120(b).
[8] *Id.*
[9] 445 U.S. 425 (1980).
[10] *Id.* at 438.
[11] *See, e.g.*, *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1990) (reiterating the *Mobil* three-factor test).
[12] 447 U.S. 207, 224 (1980).
[13] *MeadWestvaco Corp. v. Ill. Dep't*, 553 U.S. 16 (2008).
[14] 60 Cal.2d 406 (1963).
[15] 36 Cal. App. 4th 1794, 1805 (1995).
[16] FTB Notice 92-4 (Aug. 18, 1992); FTB Multistate Audit Technique Manual, section 3030.
[17] FTB Notice 89-713 (Oct. 31, 1989).
[18] *Id.*
[19] Cal. Code Regs. title 18, section 25110(b)(5).
[20] *See, e.g.*, *Richmond Wholesale Meat Co. v. Franchise Tax Bd.*, 36 Cal. App. 4th 990 (Cal. Ct. App. 1995); *Dental Ins. Consultants Inc. v. Franchise Tax Bd.*, 1 Cal. App. 4th 343 (Cal. Ct. App. 1991); *Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Bd.*, 229 Cal. App. 3d 784 (Cal. Ct. App. 1991).

deemed "instantly" unitary is limited to administrative decisions. In those decisions, the California State Board of Equalization relies on the traditional factors indicating a unitary business, such as the existence of centralized management or a vertically integrated business when acquired, rather than creating a bright-line test.

For example, in the *Appeal of Dr Pepper Bottling Company of Southern California*, the BOE found that Dr Pepper Bottling Co. of Southern California (DPSC) was unitary with Dr Pepper Co. (DPC) immediately after being acquired because before the acquisition, DPSC was a licensee of DPC, DPSC purchased 50 percent of its concentrate and syrup from DPC, and most of DPSC's sales were made up of Dr Pepper products.[21] The BOE concluded that relationship constituted a vertically integrated enterprise that became a unitary business once unity of ownership was achieved.[22] Conversely, in *ARA Services Inc.*, the BOE found that a parent company was not instantly unitary with its newly acquired subsidiaries, because centralized management was lacking.[23] While those decisions provide guidance regarding instant unity, the lack of a bright-line rule and reliance on sparse judicial guidance create another area of uncertainty and litigation for California taxpayers.

E. New York's Unitary Law

Under New York's new unitary combination law, a unitary business exists when ownership thresholds are met.[24] New York has not defined a unitary business statutorily or by regulation.

New York does have some unitary jurisprudence, since New York courts have adopted the *Mobil* three-factor test.[25] To date, New York has not issued any guidance on whether it intends to follow prior jurisprudence or to establish different criteria for determining the existence of a unitary business under its new combined reporting regime. Similarly, New York has no firm statutory, regulatory, or judicial guidance on instant unity. New York may wish to formalize its positions on those important topics to provide greater certainty to taxpayers and tax officials.

Although many questions remain, New York's new legislation created a unique tool — an affiliate group election — to help with determining the composition of a combined return. That election will allow taxpayers to include all members of their commonly owned group that meet a greater than 50 percent ownership threshold without regard to whether a unitary relationship exists among the affiliates.[26] The election must be made on the group's original, timely filed corporate franchise tax return, and is irrevocable and binding for seven years starting on the first tax year that the election is made.[27] The election renews automatically for another seven years unless the group affirmatively revokes the election.[28] If affirmatively revoked, the group may not make the election again for three tax years. Newly acquired members of a combined group that have an election in place must also be in the combined group and will be deemed to have waived any objection to their inclusion in the combined group.[29]

Although the option to elect combination under the new regime appears to be a tool to offer predictability for taxpayers, the election creates other ambiguities that should be addressed. For example, it is unclear whether a target that has an election in place will also bind an acquiring company. To illustrate that point, assume a large pharmaceutical company (which does not have an election in place) decides to buy a small lab composed of three corporate entities that have made New York's combination election. Will the election of the small lab group "infect" the large pharmaceutical company? That issue existed in California with regard to its water's-edge election. Regulatory amendments were required to remedy the harsh California tax consequences of the previous example.[30]

Thus, the combination election could create traps for the unwary in mergers and acquisitions. That risk should be balanced against the benefit of providing taxpayers with predictability, which could save taxpayer and state resources. It is unclear whether New York taxpayers will opt to use the combination election given all those factors.

II. Who Are Potential Unitary Group Members?

After determining the constitutional limits of who may be in a unitary group, the next issue is which entities are, by

[21] *In the Matter of Dr Pepper Bottling Co. of S. Cal.*, No. 90-SBE-015 (Dec. 5, 1990).

[22] *Id.*

[23] *ARA Servs. Inc.*, No. 93R-SBE-0262 (May 1997); *see also Appeal of Boston Scientific Corp.*, SBE Dkt. No. 244314 (Feb. 8, 2005) (finding that parent and newly acquired subsidiary were not instantly unitary, but unitary three months after acquisition once all departments, executive staff, and operations had been combined and integrated).

[24] N.Y. Tax Law section 210-C(2).

[25] For example, in *In the Matter of the Petition of Sungard Capital Corp. and Subsidiaries*, DTA Nos. 823631, 823632, 823680, 824167, and 824256 (N.Y. Div. Tax. App. 2014), the administrative law judge examined the criteria comprising the three-factor test in *Mobil*: centralized management, economies of scale, and functional integration. The judge determined that the group in question did not make up a unitary business based on evidence that the centralized operations were limited to oversight and there was no shared operational expertise. That decision is being appealed. *See also In the Matter of British Land (Md.) Inc. v. Tax Appeals Tribunal*, 85 N.Y.2d 139 (N.Y. Ct. App. 1995) (confirming the Tax Appeals Tribunal's use of the *Mobil* three-factor test to determine the existence of a unitary business); *Panavision Inc. for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax*, No. 816660 (N.Y. Div. Tax App. 2000) (noting that the entities in question lacked the *Mobil* factors and found that the entities were not engaged in a unitary business).

[26] N.Y. Tax Law section 210-C(3)(a).

[27] N.Y. Tax Law section 210-C(3)(c).

[28] *Id.*

[29] N.Y. Tax Law section 210-C(3)(b).

[30] *See* Cal. Code Regs. title 18, section 25111.

statute, includable in the combined group for any given jurisdiction. This section provides an overview of California's statutory rules as they relate to the inclusion of foreign entities, partnerships, and other special entities in a combined group, and it contrasts California's rules with New York's.

A. Ownership Test

To be in a unitary group, a taxpayer first must meet the state's ownership test. California and New York share similar common ownership definitions for combination. Both states define common ownership as more than 50 percent of total voting power or constructive ownership by the same entity.[31]

Interestingly, the affiliate requirement for federal corporate income tax consolidation purposes is 80 percent of the total voting power and stock value by the same entity.[32] Because of that difference, California's and New York's unitary group may have a different member composition than the federal consolidated group. That federal/state difference can create compliance burdens, including the separate tracking of intercompany transactions.

B. Water's Edge and the Inclusion of Foreign Entities

Unlike New York, which has a mandatory water's-edge regime, California uses worldwide combination as its default. However, California law permits taxpayers to make a water's-edge election, under which six classes of entities are wholly or partially in a water's-edge group.[33] The wholly included entities are:

- domestic international sales corporations and foreign sales corporations;
- corporations, other than banks, with 20 percent or more average apportionment factors within the United States, regardless of where incorporated;
- corporations incorporated in the United States, more than 50 percent of whose stock is owned or controlled directly or indirectly by the same interests, except for corporations making an election under IRC section 936; and
- export trade corporations.

Partially included entities are:

- foreign incorporated banks and corporations not meeting any of the four categories above if they have effectively connected income with a U.S. trade or business or U.S.-source income that is "business income" under California law, whether it is ECI for federal purposes; and
- controlled foreign corporations, as defined in IRC section 957, that earn subpart F income. The income and apportionment factor denominator amounts of such entities are included based on the ratio of the total subpart F income of the entity for the year to its current year earnings and profits (that is, the inclusion ratio).[34]

Historically, New York taxpayers had to rely on rulings and form instructions to address the taxation of CFCs and subpart F income.[35] Under New York's new combined reporting regime, the water's-edge combined report will include "alien" or foreign corporations treated as domestic corporations, as defined in IRC section 7701, under any provision of the IRC, as well as foreign corporations that have ECI.[36] The simplified inclusion rules may avoid some of the complexities encountered by California's regime.

C. Inclusion of Partnership Income

California addressed the challenges involved with including partnership income in combined returns through a regulation adopted in the 1970s. That regulation contains detailed instructions and examples and addresses the taxation of partnership income from unitary and non-unitary

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[31]Cal. Rev. & Tax. Code section 25105(b); N.Y. Tax Law section 210-C(2)(a). Code section 25105(e) provides California's constructive ownership provisions. For example, stock owned by a corporation or by a member of a controlled group of which the corporation is the parent corporation is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation. Before that statutory clarification of the constructive ownership rules, it was unclear whether effective common control between related individual stockholders was sufficient to satisfy the 50 percent ownership test. *See Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Bd.*, 229 Cal. App. 3d 784 (Cal. Ct. App. 1991) (holding that a corporation and its affiliated corporations satisfied the 50 percent ownership requirement when virtually all of the corporations' stock was held by a mother and her children, and all of the corporations were operated on a consensus basis, maintaining strict ownership or control within the family). Also note that New York previously defined related corporations based on 80 percent or more of voting power or constructive ownership by the same entity. N.Y. Tax Law section 211(4)(a) (2014); 20 N.Y. Comp. Codes R. & Regs. section 6-2.2(a)(3).

[32]26 U.S.C. section 1504(a)(2).

[33]Cal. Rev. & Tax. Code section 25110(a).

[34]Before 2006, there was an arguable gap in California's water's-edge law. In an either/or fashion, then-existing law required inclusion of some foreign corporations' ECI and CFCs' subpart F income. Cal. Rev. & Tax. Code section 25110(a). That created an inconsistency in the water's-edge regime because the statutory language could be interpreted to provide for two separate and mutually exclusive categories of foreign corporations that could be in the water's-edge combined group. *Id.* Many California taxpayers claimed that once a CFC became a California taxpayer (that is, established nexus by qualifying to do business in California), it was no longer subject to the CFC rules. As a consequence, those taxpayers included only the CFC's U.S.-source income and factors in the water's-edge return and excluded the CFC's subpart F income. *Id.* California revised its combined reporting tax law in 2005 to address the application to CFCs. Under the 2005 revision, a CFC, regardless of whether it is a California taxpayer, must include its U.S.-source income and subpart F income in its group's combined return. Cal. Rev. & Tax. Code section 25110(a)(2)(A)(ii).

[35]N.Y. Advisory Opinion TSB-A-02(5)C (May 31, 2002); N.Y. State Dep't of Taxation and Finance, forms CT-3-A, CT-3-A/ATT, and CT-3-A/B Instructions (2013).

[36]N.Y. Tax Law section 210-C(2)(b).

partnerships, intercompany transactions, and the reconciliation of different accounting periods and methods.[37]

California treats partnerships as passthrough entities that are not members of a unitary group. However, when a partnership and a corporate partner are engaged in a unitary business, the corporate partner must include its distributive share of the partnership's business income or loss in apportionable income and the partner's proportionate share of the partnership's apportionment factors in its combined group apportionment formula.[38] Importantly, California disregards the 50 percent common ownership requirement and the location of the partnership's activities when determining whether the partner and the partnership are engaged in a unitary business.[39] If the partnership and the corporate partner are not engaged in a unitary business, the partner's share of the partnership's income is treated as a separate business of the partner, and the partner must apportion that income using only the partnership's apportionment factors.[40]

New York's combined reporting legislation provides that a corporate partner will not be required or permitted to file a New York combined return if the corporate partner's only connection with New York is a limited partner interest in a partnership doing business, employing capital, owning or leasing property, maintaining an office within the state, or deriving receipts from activities within New York, and if none of the corporate partner's related corporations are subject to New York's corporate franchise tax.[41] Although that provision provides a bright-line test of when a partner will not be subject to New York tax, it does not address how partnership income will be treated if it is subject to tax.

New York's franchise tax regime provides two methods to compute a partner's share of partnership income: the aggregate method, which is New York's preferred method; and the entity method.[42] A taxpayer must use the aggregate method if it has access to the information necessary to compute its tax using the aggregate method.[43] Under the aggregate method, a corporate partner is viewed as having an undivided interest in the partnership's assets, liabilities, items of receipt, income, gain, loss, and deductions, and is treated as participating in the partnership's transactions and activities.[44] Under the entity method, a partner is treated as a separate entity and as owning an interest in the partnership entity; the interest is an intangible asset that constitutes business capital.[45] New York has indicated that both methods will apply to the new regime, with a continued requirement that taxpayers use the aggregate method if it has the access necessary to compute its tax liability using that method.

D. Inclusion of Specialized Industries

California and New York have addressed the inclusion of some specialized industries in a combined group. In California, unitary real estate investment trusts and regulated investment companies are in the combined group.[46] Insurance companies are not in a combined group.[47]

New York's combined reporting regime includes only captive REITs and captive RICs that are not required to be in the insurance tax combined return under article 33,[48] as well as overcapitalized captive insurance companies.[49] Given New York's robust insurance and financial industry, the state should consider industry-specific guidance to aid some financial industries in determining their corporate franchise tax liability under the new regime.

E. Terminating Group Members

In addition to the challenges involved with determining which types of entities to include in a combined group, states with combined reporting regimes face issues associated with entities exiting the combined group. Under Cal. Rev. & Tax. Code section 25105, membership in a combined group will be terminated when the 50 percent ownership threshold (determined by total voting power or constructive ownership) is no longer met.[50] Membership in a combined group will not be terminated when the stock of a member corporation is sold, exchanged, or disposed of, and the 50 percent of total vote or constructive ownership test is met again immediately after the sale, exchange, or disposition.[51] The combined group may remain intact if the 50 percent of total vote or constructive ownership test is met again within two years.[52]

New York does not have any guidance to address the departure of a combined group member. Given that group member departures are common, New York should consider

[37]Cal. Code Regs. title 18, section 25137-1(a).

[38]The FTB is considering amendments to the existing partnership regulation, Cal. Code Regs. title 18, section 25137-1, and associated provisions of other applicable regulations. Amendments under consideration include, but are not limited to, clarifying sales factor treatment of partnership interests, addressing tiered partnerships, and addressing indirect ownership of business assets. *See* FTB, Interested Parties Meeting Regulation section 25137-1, Apportionment and Allocation of Partnership Income (Oct. 18, 2013).

[39]*Id.*

[40]Cal. Code Regs. title 18, section 25137-1(g).

[41]N.Y. Tax Law section 210-C(2)(c).

[42]20 NYCRR 3-13.1; 3-13.2.

[43]20 NYCRR 3-13.2(a).

[44]20 NYCRR 4-6.5(a)(1); 3-13.1(b).

[45]20 NYCRR 4-6.5(b); 3-13.1(c).

[46]Cal. Rev. & Tax. Code sections 24871, 24872.

[47]FTB, Legal Ruling 385 (1975). California's exclusion of insurance companies from the combined report appears to be an unintended consequence of how the apportionment statute was drafted, rather than a natural result flowing from unitary theory.

[48]N.Y. Tax Law section 210-C(2)(b).

[49]N.Y. Tax Law sections 210-C(2)(b), 211(4).

[50]Cal. Rev. & Tax. Code section 25105(b), -(c)(2).

[51]Cal. Rev. & Tax. Code section 25105(c)(2)(A).

[52]Cal. Rev. & Tax. Code section 25105(c)(2)(B).

promulgating rules addressing that situation to give taxpayers more certainty in their filing positions.

III. Conclusion

New York's new combined reporting regime shares many traits with California's regime. New York's deviations from California law, such as its simplified water's-edge rules and the affiliate group election, should provide taxpayers and tax officials with greater certainty. However, New York could learn from California's long and often litigious history and begin with a relatively clean slate. Hopefully, New York will exercise its opportunity to provide taxpayers and tax officials with more guidance and certainty as they embark into this new era. ✰