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The Unitary Concept
In the Allocation of Income

By Frank M. Keesling* and John S. Warren**

For jurisdictional reasons in the case of foreign corporations and policy reasons in the case of domestic corporations, virtually all states which impose taxes on or measured by the income of corporations confine the tax to income from sources within the taxing state. Hence in every case where a corporation derives income from property located or activities carried on both within and without the taxing state, it is necessary to segregate the income from sources within the taxing state from the total income.

Complex modern business arrangements frequently involving the use of numerous affiliated corporations, sometimes as many as several hundred, often make the problem of segregation extremely difficult. It is accordingly important that the administrative agency charged with the responsibility of enforcing a tax on or measured by income be given broad discretionary powers in dealing with the problem. The California law which permits the California Franchise Tax Board to select any method which is fairly calculated to determine the net income derived from or attributable to sources within the state is exemplary in this respect.¹

Specific Allocation According to Source

Certain classes of income, such as rentals from real property, gains and losses from the sale or other disposition of capital assets, interest, dividends, and other income from intangibles are customarily attributed to the state where the property from which derived is located or is deemed to be located. This general practice is followed in California,² but a curious exception is made in the case of gains or losses de-

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¹ Cal. Rev. & T.C. § 25101.
rived from the sale or other disposition of property used in a unitary business. Regulations of the California Franchise Tax Board imply that such gains and losses should be apportioned in the same manner as general business income and thus should be apportioned among the various states and countries in which the business is conducted.\(^3\)

The exception is highly questionable. Gains or losses from the sale or other disposition of property are attributable to fluctuations in market values. For the most part such fluctuations occur irrespective of whether the property is used in business at all, and if used in business, irrespective of where the business is carried on. Hence it seems clear that the methods appropriate for apportioning general business income are inappropriate for the apportionment of capital gains and losses even though the property is employed in the business. If it is proper specifically to assign capital gains and losses to the state where the property is located, in cases where the property is not used in business and in cases where the property is used in a separate business, it is proper to follow a similar practice in the case of gains and losses resulting from the fluctuation of values of property used in a unitary business.\(^4\)

**Allocation Methods**

In the apportionment of business income two methods have been devised which have come to be known as the “separate accounting” method and the “formula” method, respectively. Under the separate accounting method, as the name implies, the business within the state is treated separately and distinctly from the business outside the state and the income is computed in much the same manner as it would be if the taxpayers’ activities were confined solely to the taxing state. The gross income from the business activities within the state is first determined. The allowable deductions are then subtracted. The remaining net income is attributed in its entirety to the taxing state.

Under the formula method the business activities within the state are considered to be an inseparable part of a business carried on both within and without the state. The total gross income from the entire business is determined. The allowable deductions are then subtracted and the remaining net income is apportioned within and without the state by means of an allocation formula consisting of various factors which are thought to be relevant in the production of income, such as property, payroll, and sales.

It has become almost axiomatic that the separate accounting method should be employed in the case of separate businesses and

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3 Ibid.

4 For a more extended discussion of this subject, see Altman & Keesling, Allocation of Income in State Taxation, 83 (1950).
the formula method in the case of unitary businesses. The rule is amply supported by both reason and authority.

It has never been seriously urged that the formula method should be employed to determine the income attributable to a particular state derived from the operation of a separate business conducted therein. The profitableness of businesses may vary greatly even though conducted by the same taxpayer. Some may be extremely profitable, others less so, and still others may operate at a loss. Thus to combine the income or losses of all the various businesses and apportion by means of a formula is obviously wrong.

In contrast, it has been frequently urged that the separate accounting method should be employed to apportion the income of unitary businesses. Such a procedure is just as false as the use of the formula method to allocate the income of separate businesses.

To apply the separate accounting method, it is necessary to determine separately, (1) the gross income attributable to the taxing state and, (2) the deductible expenses attributable to such state. Where the business within the state is truly separate and distinct from the business without the state, such determinations can be made fairly easily and accurately. Where however the activities within the state are not a separate business, but instead are a portion of a business carried on within and without the state, substantial difficulties will be encountered in making such determinations. Although segregated figures for both income and expenses can be computed, they must necessarily reflect numerous arbitrary determinations based largely on conjecture and guess. For example, a company is engaged in the manufacture of goods in one state which it sells partly in that state and partly in a number of other states. It derives a gross income, i.e., difference between receipts and cost of goods sold of $1,000,000. Its total operating expenses amounts to $900,000. It thus has a total operating net income of $100,000.

If the separate accounting method were to be used in such a case, it would be necessary to determine piece-meal how much of the total gross income is attributable to each of the various functions or activities conducted in each of the different states involved. Such an approach is both impractical and unreliable.

A similar determination must be made with respect to the expenses.

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The following are the leading cases on the subject, all of which upheld the use of the formal method: Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 133 (1920); John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214, 238 P.2d 569 (1951), appeal dismissed, 343 U.S. 939 (1952); Butler Bros. v. McColgan, 17 Cal. 2d 664, 111 P.2d 334 (1941), aff'd, 315 U.S. 501 (1942).
Similar difficulties are encountered. The expedient of assigning the expenses to the state in which they happen coincidentally to have been incurred is obviously no answer. In the case of a unitary business the expenses incurred in any particular state are not incurred solely in furtherance of the business within the state's borders and should not be so considered. Instead, they are incurred in furtherance of the business as a whole and should be so charged. As stated in *John Deere Plow Co. v. Franchise Tax Board.*

With regard to a unitary business, the place where expenses affecting the entire business are incurred has little or no bearing on the question of how such expenses should be allocated. Thus, in the situation here involving the manufacture and sale of goods as a composite enterprise, selling expenses in one state may logically affect the amount of income realized from sales in other states through the following chain of processes: more sales in the aggregate, calling in turn for an increase in production, resulting in a reduced per unit cost, in consequence of spreading certain fixed or more or less constant charges over a broader base and increasing purchasing power so as to lessen the cost per unit of raw material, with the decrease in unit cost of goods manufactured causing an increase in the profit or income gained from sales in other states.

In *Butler Bros. v. McColgan* one of the leading cases on the subject of the use of the separate accounting method in apportioning the income of a unitary business, the California Supreme Court held that such method may properly be used only where the business within the taxing state is truly separate and distinct from the business without the state, so that the segregation of income may be made clearly and accurately. The court further held that where interstate operations are carried on and the portion of the business within the state cannot be clearly segregated, the business should be treated as a unit, the entire net income from the entire business should be computed, and the share attributable to the activities within the taxing state should be determined by means of an appropriate allocation formula.

**Distinction Between Separate and Unitary Businesses**

Since the use of one method of allocation rather than the other may result in substantial differences in the amount of income attributed to the taxing state, it is important to determine the characteristics which distinguish a separate business from a unitary business. Specifically what is a "separate" business and what is a "unitary" business?

No distinction can be made in this respect on the basis of any inherent or intrinsic difference in the nature of businesses. The distinction

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7 17 Cal. 2d 684, 111 P.2d 334 (1941).
lies solely in the difference in the relationship of various businesses to the taxing jurisdiction. Where a company is engaged in the conduct of two or more businesses, the term "separate" is often used with reference to one of the businesses in a general or ordinary sense to indicate simply that the business is separate and distinct. This general usage may be employed irrespective of the location of the various businesses with reference to any particular taxing jurisdiction. For example, a company is engaged in the operation of a number of different businesses each of which is conducted partly within and partly without a particular taxing state. In such a case, the term separate may be employed to indicate that each business is a distinct business and not simply a portion of one or more of the others.

As used, however, in contradistinction to unitary, the designation of a business as separate means simply that it is conducted wholly within a particular taxing jurisdiction and that the income attributable to that jurisdiction may appropriately be determined by use of the separate accounting method without taking into account income from property or activities located or carried on beyond the borders of the taxing jurisdiction. The method of apportionment to be employed is implicit in the classification.

Where the properties and activities within the jurisdiction are an inseparable portion of a business carried on within and without the jurisdiction, the computation of the income attributable thereto requires a computation of the income of the business as a whole or as a unit and an apportionment or allocation of the total to the various parts. This necessity of dealing with the business as a unit taking into account income from property and activities without the jurisdiction as well as within, gives rise to the classification of the business as a unitary business. Thus a unitary business may be defined simply as any business which is carried on partly within and partly without the taxing jurisdiction.

As the relationship of a business to a given taxing jurisdiction changes, the classification as separate or unitary also changes. For example, a company commences a manufacturing and selling business in State A. As long as the business is conducted wholly in that state, it is, with reference to that state, a separate business. Later the company opens wholesale or retail selling outlets in neighboring states. Although there is no inherent or intrinsic change in the nature of the business and the company is still engaged in the same business, because of the extension of the business into other states, the classification changes from separate to unitary.

A change in classification may also result from a change in juris-
dictions. Thus a business carried on in two or more states is, with reference to any of such states, a unitary business. For federal income tax purposes, however, such a business, if conducted wholly within the United States, would be a separate business. In the other direction, a business conducted wholly within a given state is a separate business for that state's income tax purposes. If, however, the business is carried on in two or more political subdivisions of the state and if, heaven forbid, we should ever become concerned with allocation of income between political subdivisions, the business for such purposes would be a unitary business.

This chameleon-like aspect of a business—a change from separate to unitary and back to separate again without any change in the intrinsic nature of the business—may seem strange indeed. Actually there is nothing unusual about it. Our conceptions of unity are largely a matter of emphasis and are often teleologically inspired. They vary as the purposes vary. Thus for certain purposes a continent may be considered a unit. For other purposes it is a composite of a great many other things such as mountain ranges, rivers and lakes which are considered units. For still other purposes, a continent may be considered a portion of the earth which is the unit and which is in turn considered a portion of the solar system, and so on indefinitely in either direction until the limits of conceptual ability are reached.

The foregoing analysis of the distinction between separate and unitary businesses differs sharply from much of the previous thinking on the subject. The notion persists that there is some fundamental or intrinsic or inherent difference in the nature of such businesses and that that difference can be expressed in terms which either ignore the difference in relationship to the taxing jurisdiction, or which do not emphasize such difference as the sole criteria of definition. Thus it is common to define a unitary business as one in which there is: (1) unity of ownership; (2) unity of use; (3) unity of management. These glib superficial phrases are at best ambiguous, if not actually meaningless. Whatever meaning, if any, they have would seem equally applicable to a business conducted wholly within a state as to a business conducted partly within and partly without the state. In any event, the definition is of but little if any value since it fails to afford a hint or

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8 See Butler Bros. v. McColgan, 17 Cal. 2d 664, 678, 111 P.2d 334, 341 (1941) where the California Supreme Court stated that a business was unitary because of the presence of the following circumstances: “(1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operation.” See John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214, 229, 238 P.2d 569, 577 (1951).
clue, let alone a reliable guide, for determining in particular cases which method of allocation should be employed.

Another common definition of a unitary business is "one where the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state." This definition is a vast improvement upon the one previously discussed. At least it recognizes that a business, to be unitary, must be conducted partly within and partly without the taxing jurisdiction. It is deficient however in that it does not clearly indicate that such a relationship to the taxing jurisdiction is the sole criteria for distinguishing between separate and unitary businesses. Furthermore, the use of the word "dependent" is confusing and misleading. Dependency suggests liability. If the activities within a given state are only dependent upon the activities out of the state, and do not contribute to the earning of income, they should not be credited with any portion of the income derived from productive activities outside the state. Hence, contrary to the implication of this definition, where the activities in a given state are dependent only, they should not be considered as constituting a portion of a business which includes activities in other states which do contribute to the earning of income.10

Meaning of a "Business" for Allocation Purposes

In applying the foregoing definitions, it must be kept clearly in mind that although in particular instances all the activities of a given taxpayer may constitute a single business, in other instances the activities may be segregated or divided into a number of separate businesses. It is only where the activities within and without the state constitute inseparable parts of a single business that the classification of unitary should be used.

The description of a group of activities as a business implies the existence of a unit, which in turn implies that the different activities have something in common, which leads to their inclusion in the unit. The elements or features which are commonly considered to form a nexus between otherwise separate activities so that they may be referred to as a business, are numerous and varied. The term "business" is sufficiently elastic so that it would not be stretching it unduly to suggest that all productive activities in the United States constitute a business. The common connecting feature is the fact that they are all conducted in the United States. Expressions commonly used, such as the "oil business," the "steel business," the "automobile business,"

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10 See illustrative examples 3 and 4, infra.
are only slightly less extensive. For various purposes, it is common to consider that all of the activities conducted by a given company constitute a single business particularly if they are similar in nature. Thus, for instance, a company engaged in the operation of a chain of hotels in a number of different states might well be referred to as engaged in the hotel business, thus implying that it is operating only one business rather than a number of different businesses.

These and other general usages cannot be relied upon to distinguish between separate and unitary businesses in the allocation of income. Greater discrimination is required. Since we do not normally tax one entity on the income of another, or combine incomes of different owners in order to compute the taxable income of one, separate ownership alone requires separation of treatment, no matter how closely the business activities are otherwise integrated. Other distinctions must also be made.

Briefly stated, for the purposes of allocation of income, a business may be defined as a separately owned group of activities each of which contributes to the production or earning of a given identifiable item of income, no portion of which can be segregated and specifically identified as being attributable to any one of the activities or any combination of activities less than the total number included in the group. In some instances, this relationship may exist between all of the activities conducted by a given taxpayer and its entire income. A company which derives its entire income from the manufacture of a product in one state and the sale of the product in such state and other states is a common example of the existence of such a relationship. The income is attributable in part to all of the activities, manufacturing, selling, accounting, management, and purchasing, etc., which must be engaged in to produce the income. No portion of the income can be specifically identified as being derived from or attributable to, any one of these activities. Due to this relationship to the common income, all of these activities may be considered as constituting portions of a single business unit. Since, as indicated, the activities are located in a number of different states, the business is clearly unitary and the formula method should be employed to apportion the entire net income among the various states.

As indicated previously, it is a common practice to segregate certain classes of income, such as rentals from real property, capital gains and losses, etc., and assign them to the state where the property from which derived is located or deemed to be located. A similar pro-

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11 See text at note 2 supra.
procedure can often be followed with respect to items of business income. Out of the total income of a company, it is often possible to identify certain items as being attributable to a particular series or group of activities. Wherever this is possible, each group or series of activities should be considered a separate business unit. Hence for allocation of income purposes, a given taxpayer may be engaged in the conduct of a number of different businesses notwithstanding that for other purposes it might be considered as engaged in only one business, such as the hotel business, the cotton business, etc. Furthermore, one or more of such businesses may be conducted wholly within a given taxing jurisdiction, one or more partly within and partly without and others wholly without the jurisdiction. In the first case, the businesses are separate and the income can be computed by the separate accounting method. In the second case the businesses are unitary and the income from each, if there is more than one, should be apportioned by the formula method. In the third case, since the businesses are conducted wholly outside the taxing jurisdiction, they can be ignored and hence there is no need for classification.

Operational Unity

The relationship between a series of activities and income which leads to the conclusion that the activities should be considered as a business unit or a single business, may be of two kinds with which will be associated the phrases “operational unity” and “economic unity,” respectively. Operational unity occurs wherever property or the services of individuals directly contribute to the earning of income, which is the inseparable product of these combined elements. The example previously mentioned of a company engaged in the manufacture of goods in one state and the sale thereof in a number of states, is also an example of operational unity. All of the property and services involved in the manufacturing and selling operations, including the functions of management, accounting, etc., which are incidental thereto, directly contribute to the earning of the income resulting from the sale of the product.

Again, a company operates a mine in State B, where ore is extracted, processed, and sold. It maintains a headquarters office in State A, where management financing, and accounting functions are performed. All of the activities in both states clearly contribute to the earning of a common income, no portion of which can be specifically segregated and assigned to any one of the activities. Because of the operational unity, which is clearly present, the activities in both states should be considered as constituting portions of a single business.
Economic Unity

Economic unity exists where there are two or more series of activities, which from an operational standpoint, are separate and distinct from one another, but which because of economic interrelationship, should be considered as constituting a single business. For example, a company like the taxpayer in Butler Bros. v. McColgan\textsuperscript{12} is engaged in the operation of seven department stores, each of which is located in a different state, one of the states being California. The head office is located in one of the eastern states, where the activities in the different states are managed and supervised, accounting functions are performed, and merchandise is purchased for all of the stores. From an operational standpoint, there are seven separate series of income-producing activities with certain functions—management, supervision, etc., being performed centrally on behalf of each series. Each of the series encompasses a store, operated in one of the seven states, and in addition a portion of the activities in the central office which is reasonably attributable to each of the stores.

Based upon these facts alone, each series should be considered as a business distinct and apart from the others and each should be considered, in turn, as a unitary business carried on partly in the state where each store is located, and partly in the state where the functions common to all of the stores are performed. It further appears, however, that by virtue of operating a number of stores, rather than one, the company is able to purchase in larger quantities and by that means, to obtain more favorable prices than would otherwise be the case. The purchasing profit thus obtained is a substantial and important element in the financial success of the company’s activities. Since each of the series of activities contributes to the advantage thus obtained, the several series, which, from an operational standpoint would be considered as distinct businesses, become welded into a single business. As the California Supreme Court in the Butler Bros. case stated:\textsuperscript{13}

\begin{quote}
But it is able to buy in large quantities only because it is able to sell in large quantities, so that it is apparent that the purchasing saving is made possible only because of the sales. Furthermore, it is pertinent to observe that the saving is not turned into profit until the sales are made. Thus, the purchasing activities and the sales activities are interdependent and supplement one another to form one single, unitary business.
\end{quote}

A very similar example of economic unity is afforded by so-called

\textsuperscript{12} Butler Bros. v. McColgan, 17 Cal. 2d 664, 111 P.2d 334 (1941), aff’d, 315 U.S. 501 (1942).

\textsuperscript{13} Id. at 669, 111 P.2d at 337.
“small loan” companies which are in fact large loan companies—large in the sense that they operate in a number of different states and in the course of a year engage in financial transactions running into many millions of dollars. Although the lending offices in each state may process loans only for customers located in that state, and in that sense there is a certain element of operational separateness, by dealing in a large volume of loans, the companies are in a better position to obtain the necessary bank financing and at lower rates than would otherwise be the case. These elements are sufficiently consequential to require that all of the activities in the various states be considered for allocation purposes as portions of a single business.

Although the obtaining of a purchasing profit, through the acquisition of merchandise at lower costs or obtaining money at lower interest rates, are the most common examples of economic unity, essentially similar advantages may be obtained in other ways, such as, for example, through the central manufacturing of products which permit the spreading of labor, depreciation, and other costs over a larger volume, thereby resulting in lower per unit costs of manufacture.

It may well be that in many instances the central performance of certain functions on behalf of a number of commonly owned series of business activities, which from an operational standpoint, are separate businesses, may result in savings substantially similar to those just discussed. Before, however, it is concluded that the different groups of activities should be considered as constituting one business, it should clearly appear that the savings and advantages are substantial in relation to the income involved. Central accounting, for instance, may result in some savings, but in most instances the amount is trifling in comparison with the income of the various series of business activities for which the accounting is performed. Alone considered, it is too weak a connecting link to bind into one business, what would otherwise, from an operational standpoint, be considered separate businesses. Similar observations may be made with respect to other centrally performed functions such as management, handing of insurance, advertising, and the purchasing of supplies and equipment.

Illustrative Examples

The following examples may serve to illustrate some of the foregoing principles.

Example 1. A company with a commercial domicile in California, where its headquarters are located, is engaged in the operation of a system of railway lines throughout the western part of the United States. Over the years it has accumulated large reserves which are invested for the most part in stocks and bonds of other companies, from
which it derives substantial income in the form of dividends and interest. The investment activities are carried on in the headquarters' office where the railroad operations are managed and controlled. Some individuals devote their entire time to the investment activities, whereas others, including a number of officers, devote part of their time to both the investment activities and the railroad operations.

Although both activities are commonly owned and managed, and there is some common use of personnel and facilities, and although some practical difficulties may be experienced in segregating the expenses of the investment activities, clearly it would be wrong to consider that the company is engaged in only one business and that the entire income of the company should be apportioned within and without the state by means of a formula. Notwithstanding the common elements, there are two distinct series of income-producing activities. This conclusion follows from the fact that the income from dividends and interest can be identified as being derived from the stocks and bonds and the activities related thereto, and not in any way attributable to the general railroad operations carried on within and without the state. Since stocks and bonds and other intangibles are considered to have a location at the commercial domicile of the owner, and since all of the investment activities take place in California, the investment income should be computed separately and assigned entirely to California.

The income from the railroad operations can likewise be identified as being derived from a distinct series of transactions, which should be considered as constituting a business separate and distinct from the investment activities. Since the railroad operations are carried on partly within and partly without the state, it is a unitary business and hence the income from the railway business as a whole should first be computed and apportioned within and without California by means of an appropriate allocation formula.

Example 2. The company referred to in Example 1 acquires all of the assets of a company engaged in the production and sale of oil, such activities being carried on entirely within the State of Texas. These activities are continued in the same manner after the acquisition. They prove very profitable and result in a net income of some $10,000,000, computed by the separate accounting method. Notwithstanding the common ownership, the production and sale of oil should be regarded as a business separate and distinct from both the railroad and investment activities. The net income therefrom should be computed sepa-

rately, and should be considered as being derived from sources in Texas, and no portion of it allocated to California.

Instead of selling the oil separately, the company uses all or substantially all of it in connection with its railroad operations. Under these circumstances, there will be no income which can be separately identified as being derived from the Texas oil production activities. Instead, these activities now contribute to the earning of general railway revenues and, accordingly, should be considered as constituting an integral part of the unitary railway business. The property and payroll of the oil producing activities should be included in the property and payroll factors of the allocation formula and, consequently, some portion of the over-all railway income will be apportioned to such activities.

If a substantial portion of the oil production were separately sold in the manner indicated in the first paragraph of this example, and if the remainder were used in the railroad operations in the manner indicated in the second paragraph, the oil production activities should be regarded as being partly separate and partly unitary. The income from the sale of oil should be computed separately and allocated to Texas. The remainder of the oil should be considered as used in furtherance of the unitary railway business. In applying the formula, only a prorata portion of the property and payroll of the oil productions activities should be included in the property and payroll factors.

Example 3. A company is engaged in the production and sale of cotton exclusively in the State of California. The operations are quite profitable and, since they are carried on entirely in the state, all of the income is attributable to California. The company acquires a copper mine located in Arizona which has been operating at a substantial loss. The company believes that by furnishing the necessary capital for further exploration and the sinking of shafts to greater depths, the operations of the copper mine can be converted from a loss into a profit.

It furnishes the necessary capital and also closely manages, supervises, and controls the mining operations. A number of functions such as accounting, handling of insurance and purchasing of supplies are centrally performed in the California offices of the company, on behalf of both the cotton business and the copper mine.

During the year following the acquisition of the copper mine, the income from the cotton business, computed by the separate accounting method, amounts to $1,000,000. Notwithstanding the extensive efforts to make the mining operations profitable, they resulted in a loss (computed in the same manner) of $500,000. The company thus made an over-all profit of $500,000 ($1,000,000 minus $500,000 equals
How much income is attributable to California and how much, if any, to Arizona?

In addition to common ownership, there is extensive common management. There is also common use of office buildings, equipment, and personnel. Under the definition of a unitary business as one in which there is unity of ownership, unity of use, and unity of management, it might be held that the combined cotton and mining operations constitute a unitary business carried on partly in California and partly in Arizona. Since the mining operations in Arizona are clearly dependent, to a substantial extent, upon the activities in California, a similar conclusion might be reached from a literal application of the definition of a unitary business as "one where the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state." Regardless of the reasoning employed, if the combined activities were held to constitute a unitary business, the income would be computed as a whole and would, as indicated, amount to $500,000. Application of the allocation formula would result in apportioning a substantial part of the over-all profit, possibly as much as half or more, to Arizona. Thus the conclusion would be reached that only some $250,000 was earned in California and a similar amount in Arizona.

The conclusion is absurdly wrong. Notwithstanding the features of common ownership, common management and common use of property and personnel, there are two separate series of income-producing activities. The income from the sale of cotton can clearly be identified as being attributable to activities carried on wholly within the State of California. The mining operations in Arizona in no way contributed to the production and sale of cotton and should not be credited with any of the net income derived therefrom. Instead, such income amounting to $1,000,000 should be attributed entirely to California.

Although the mining operations were carried on principally in Arizona, many of the activities essential thereto, such as management, accounting, purchase of supplies and equipment, were conducted in California. It is clear, therefore, that the mining operations constitute a business conducted partly in California and partly in Arizona and hence is a unitary business. The loss, accordingly, should be apportioned partly to each state.

There may be some operational savings resulting from the centralized performance of functions, such as accounting, purchasing of equipment, supplies, etc., on behalf of both businesses. It is possible,
accordingly, that there is a certain element of economic unity involved. As indicated earlier, however, such savings are apt to be slight and afford much too weak a connecting link between the two businesses to reach the conclusion that a substantial portion of the income from the cotton business was earned in Arizona, where only unprofitable mining operations were conducted.

Example 4. Assume the same facts as in Example 3, except that the California company, instead of acquiring a copper mine in Arizona, acquires land and engages in the production of cotton there, as well as in California. The relative income figures computed by the separate accounting method are the same, i.e., a profit of $1,000,000, from the production of cotton in California and a loss of $500,000, from the production of cotton in Arizona. In addition to common ownership, there is also substantial central management, supervision, and control of both businesses and central performance of a number of miscellaneous functions. Although for many purposes the company might be considered as engaged in a single business, i.e., the cotton business, for allocation purposes the fact that the activities in the two states are similar in general character is completely irrelevant. Notwithstanding the similarity, there are still two distinct businesses, one of which was conducted wholly in California and the other principally in Arizona, but also partly in California. The same allocation technique should be employed as in the previous example and the same answers obtained. Thus it should be concluded that the company derived a net income of $1,000,000 from the cotton business carried on wholly in California, and sustained a loss of $500,000 from the cotton business conducted principally in Arizona and partly in California. Part of the loss, of course, should be allocated to California and offset against the profit derived from the business conducted wholly therein.

Example 5. A company with its headquarters in New York is engaged in the operation of a number of hotels located in a number of different states, one of which is California. The operation of all of the hotels is managed and controlled from the New York office, where numerous centralized functions, such as accounting, purchase of equipment and supplies, etc. are performed.

Although it cannot be said that each hotel, alone considered, is a separate business conducted entirely in any given state, from an operational standpoint there are as many distinct businesses as there are hotels. Each hotel in each state, coupled with the activities performed centrally on behalf of it, constitutes a business unit separate and distinct from the others. This follows from the fact that the income from

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17 See text following note 13 supra.
each of the hotels can be identified as being derived from (1) the
operation of the hotel and (2) the central functions performed in New
York which contribute to its operation. From an operational stand-
point, activities in connection with the conduct of a hotel in a given
state in no sense contribute to the earning of income derived from the
operation of the hotels in the other states. Hence, in the absence of a
showing of economic unity, the income from each of the hotels should
be computed separately, one from the other.

Thus in computing the income from the California hotel, there
should first be determined the gross income derived from this opera-
tion. From this amount there should be subtracted the direct expenses
incurred in California, and in addition a proportionate part of the
common New York expenses reasonably attributable to the operation
of the California hotel. Since some of the functions which contribute
to the earning of the net income thus obtained were performed partly
in California and partly in New York, the income should be appor-
tioned, by means of a formula, between California and New York. In
the property and payroll factors of the allocation formula there should
be included, all of the property and payroll in California, plus a part
of the New York property and payroll to the extent reasonably attribu-
table to the operations of the California hotel.

In some instances, the amount of income (or loss) attributable to
the state where the central activities are performed (New York in this
case), may not be of sufficient consequence to justify the trouble and
effort involved in making the apportionment. In such cases, the appli-
cation of the formula can be omitted and the entire income attributed
to the state where the principal activities are conducted. (California
in this example).

The Multi-Corporate Unitary Business

In any case where a business would be considered unitary if con-
ducted by one taxpayer, it should likewise be so considered even
though conducted by two or more affiliated corporations. Just as a
state may look beyond its borders and take into account the entire
income of a business in arriving at a determination of the amount of
income reasonably attributable to the activities conducted within the
state, so in the case of a group of affiliated corporations engaged in the
conduct of a business, it may look at the total income of the group to
determine the amount of income attributable to the portion of the
business conducted within the state by one or more of the members
of the group.

The authority for this procedure does not rest on any special pro-
visions, such as those relating to the filing of consolidated returns or
those which authorize the administrative agency to reallocate income and deductions between related taxpayers in order to prevent the evasion or avoidance of taxes. Instead, the authority is implicit in the general provisions of the law relating to the allocation of income such as California Revenue and Taxation Code section 25101 (formerly section 10 of the Bank and Corporation Franchise Tax Act), which authorize the administrative agency to determine the income reasonably attributable to sources within the taxing state. This procedure likewise does not result in the disregard of the separate corporate entities of the various members of the affiliated group.

These principles were clearly recognized by the California Supreme Court in *Edison California Stores, Inc. v. McCollgan.* The taxpayer was one of fifteen corporations owned by one parent corporation which had its headquarters in St. Louis, Missouri. Each of the subsidiaries operated retail shoe stores in a different state. The shoes were purchased by the parent and transferred to the subsidiaries, and the parent exercised close control over all of the subsidiaries. The California Franchise Tax Commissioner (the predecessor of the California Franchise Tax Board), arrived at the income of the California subsidiary by combining the income of all of the corporations and allocating a portion thereof to California by the use of the familiar three-factor formula.

The court viewed the case as a natural extension of the *Butler Bros.* case which it had decided six years earlier. It concluded that the principles governing the allocation of income of a unitary business were the same whether that business is conducted by one corporation with several divisions, as in the *Butler Bros.* case, or by several corporations with common ownership and control, as in the *Edison* case.

The argument was made that if the transactions between the parent and subsidiaries, namely the transfer of shoes at wholesale, were at a fair price just as if made between strangers, then there was no necessity or authority for combining the income of the corporations for allocation purposes. This argument was rejected by the court for the same reason that separate accounting was rejected in this case and in the *Butler Bros.* case, that is, since the business was unitary and the profits arose from the business as a whole, the reasonableness of the intercompany accounting had no relevant bearing on the determination of the income earned by the business in a particular state.

The court also took pains to point out that combining the income of

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18 30 Cal. 2d 472, 482-483, 183 P.2d 16, 22-23 (1947).
19 See note 7 supra.
corporations for allocation purposes does not amount to a disregard of corporate entities. Rather, it is a means of arriving at the income attributable to the taxing state by taking into account the integration and interdependency that exist among related corporations.\textsuperscript{21} This point will become important later when the treatment of intercompany dividends is considered.\textsuperscript{22}

\textit{Apportionment of Income of Multi-Corporate Unitary Businesses}

The mechanics of the apportionment of income of a multi-corporate unitary business may be summarized as follows: The net income of all of the corporations is combined and intercompany sales, rents, service charges and the like are eliminated. A formula composed of the combined income-producing factors is then applied to the combined net income, and the result is the net income of the group attributable to California sources. This operation may be called the interstate apportionment.

If more than one of the corporations is doing business in California an additional step is required in order to divide the aggregate California net income among those corporations doing business in California. This step may be called the intrastate apportionment. At one time it was accomplished by using the ratio which the California factors of each corporation bore to the total California factors.\textsuperscript{23} More recently, however, the Franchise Tax Board has changed its method to use the ratio which the California factors of each corporation bear to the total factors everywhere.\textsuperscript{24}

The California income as thus determined for each of the corporations doing business in California becomes the measure of its franchise tax liability. If the corporations are closely affiliated, the separate billing of their respective taxes may seem unimportant because, in reality, all of the taxes are paid out of the same pocketbook and all are at the same five and one-half per cent rate. The matter can become critical in particular cases, for instance, where one of the members of a commencing corporation is subject to two-year liability on the same income or is a dissolving corporation entitled to a prorated refund or abatement of its tax.\textsuperscript{25} Even more critical would be a case where the tax of one of the corporations cannot be collected from it because of

\textsuperscript{21} \textit{Id.} at 481, 183 P.2d at 21-22.
\textsuperscript{22} \textit{Infra.}
\textsuperscript{23} \textit{Appeal of Kaiser-Frazer Sales Corp., et al., Cal. St. Bd. of Equal., Nov. 7, 1958; CCH 2 Cal. Tax Cases \textsuperscript{\$} 200-950; P-H State & Local Tax Serv. Cal. \textsuperscript{\$} 13185.}
\textsuperscript{24} \textit{Cal. Franch. Tax Bd., Legal Ruling 234, CCH 2 Cal. Tax Cases \textsuperscript{\$} 201-418 (Oct. 1959).}
\textsuperscript{25} \textit{Cal. Rev. & T.C. \textsuperscript{\$} 23222.}
\textsuperscript{26} \textit{Cal. Rev. & T.C. \textsuperscript{\$} 23332.}
the statute of limitations or insolvency. This problem will be considered at greater length below.27

**Intercompany Dividends**

The distinction between combining the business income of a group of affiliated corporations for allocation purposes on the one hand, and the filing of a consolidated return on the other, is most sharply drawn in the treatment of intercompany dividends. In the case of a consolidated return, all items of income and expense of all members in the group are combined. In the process intercompany dividends as well as intercompany sales, rents, and other such intercompany items are eliminated or cancelled.28

Where the business income of a group of affiliated corporations is combined for allocation purposes, intercompany items involved in the computation of the business income, such as intercompany sales, rents, and interest charges are similarly eliminated. But the similarity to a consolidated return ends here and does not extend to the treatment of non-business items such as capital gains and losses, income from securities, and other such items which are not connected with the unitary business and which may be specifically allocated according to source without the use of an allocation formula. Hence, after the business income is combined and apportioned and the share thereof of each company doing business in the taxing state is determined, appropriate adjustments must be made for the non-business items, if any.

Thus, if one of the members of the group has a domicile or commercial domicile in California, and also has income from dividends, such dividends must be separately added to its share of the business income in computing the income upon which its tax is based. Since the California law affords no basis for differentiation, this procedure must be followed not only with respect to dividends from stock representing a minority interest, but also with respect to dividends from stock representing a majority or controlling interest and even though the declaring company is a member of an affiliated group, the business income of which was combined and apportioned by means of a formula.

This conclusion regarding the treatment of intercompany dividends seems inescapably correct. Although the point has not yet been passed upon by the courts, the State Board of Equalization arrived at the same conclusion in the *Appeal of Dohrmann Commercial Company*.29 It reasoned that the law provides for inclusion in the measure of the

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27 *Infra.*


29 CAL. ST. Bd. of Equal., Feb. 29, 1956; CCH 2 CAL. TAX CASES ¶ 200-504; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13152.
tax all dividends from stock having a situs in California and that if a parent has a commercial domicile here, the stock of its subsidiaries has its tax situs here. The Board reiterated the point made by the Supreme Court in the Edison California Stores\textsuperscript{30} case that allocation of income on the basis of a combined report does not result in disregarding corporate entities. The only authority which it could find in the statute for elimination of dividends was section 8(h) of the Franchise Tax Act (now section 24402 of the Revenue and Taxation Code) which allows a deduction for dividends paid out of income previously included in the measure of the tax of the corporation paying the dividend. Therefore, the Board concluded that intercompany dividends are includible in the measure of the tax of a domestic parent corporation except to the extent they are deductible under section 24402.

**Deductible Portion of Intercompany Dividends**

The Board did not consider the manner in which the portion of the intercompany dividends deductible under section 24402 is to be determined, and this matter still remains unsettled. It is a most difficult matter to resolve because the concepts of unity (which is the basis for requiring a combined report) and separation (which is the basis for not eliminating the intercompany dividends) clash head-on at this point.

The original purpose of section 24402 was to prevent double taxation of income where one corporation subject to the California tax pays dividends to another corporation subject to the California tax. The section authorizes the payee to deduct that portion of the dividend which was paid out of income included in the measure of the payor's tax. Since a dividend, to be a dividend for income tax purposes, must be paid out of earnings and profits, the section may be paraphrased as allowing a deduction for dividends paid out of earnings and profits previously included in the measure of the tax.\textsuperscript{31} Thus the deductible portion of the dividend is equal to the ratio of the payor's earnings and profits which have been included in the measure of the tax to the payor's total earnings and profits available for payment of the dividend.

The difficulty is that the numerator of this ratio (i.e., the amount included in the measure of the tax) can be determined only by reference to the amount of income apportioned to the payor on the basis of the combined report, whereas the denominator (i.e., the amount which the payor actually has in its hands and available for payment of the dividend) can be determined only by reference to the payor's separate accounting records. It is immediately apparent that this is a

\textsuperscript{30} 30 Cal. 2d 472, 183 P.2d 16 (1947).

case of dividing apples by oranges.

The Franchise Tax Board has never issued a regulation as to how the deductible dividend computation is to be made in combined report cases. Cases presently docketed before the State Board of Equalization in which the taxpayers and the Franchise Tax Board are at loggerheads over the computation may produce some rules. Meanwhile, few taxpayers will be able to make the computations themselves and most will have to rely on the Franchise Tax Board to make the computations in a reasonable manner at the time of auditing the returns, with deficiency assessments or refunds to follow.

**Liquidation Losses**

Another problem which may arise where the parent corporation of a group making a combined report is domiciled in California is the computation of the parent's loss on liquidation (or sale of the stock) of one of the subsidiaries. Since the loss is attributable to intangible personal property (viz. stock in the subsidiary) it is wholly allocable to the state of the parent's domicile and not apportionable among the states where the affiliated group does business. However, if the subsidiary sustained operating losses in years prior to the liquidation, a portion of those operating losses would have been allocated to California by virtue of the fact that they reduced the combined net income subject to apportionment and thereby reduced the California share of the combined net income.

The Franchise Tax Board takes the position that the loss on liquidation must be reduced by the amount of the reduction in California income resulting from the inclusion of the subsidiary's operations in the combined reports for prior periods. This is necessary, says the Board, in order to avoid double deductions. It is also consistent with the federal rule in consolidated return cases. Quaere, however, whether the Board should rely on federal authorities here but reject them on the issue of elimination of intercompany dividends. Moreover, the double deductions argument seems inapt. If reducing the combined net income by the operating losses of a subsidiary and also allowing a deduction to the parent for the full loss on liquidation of the subsidiary amounts to allowing double deductions, then would not increasing the combined net income by the operating profits of another subsidiary 

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subsidiary and also including in the parent’s income the dividends received from that subsidiary amount to double taxation of income?

**Several Liability for Tax on Combined Income**

Still another problem may arise where, after the intrastate apportionment is made and the tax of each corporation doing business in California is determined, it turns out that the tax of one of the corporations cannot be collected from it because the period of limitations has expired or the corporation is insolvent. Can the Franchise Tax Board assess and collect that corporation’s tax from one of the other members of the unitary group doing business in California? The Commissioner of Internal Revenue could do so in a case where a federal consolidated return was filed, for the tax shown thereon is specifically made the several liability of all members of the affiliated group.\(^5\)

There is likewise wording in section 25104 of the Bank and Corporation Tax Law which authorizes the Franchise Tax Board to assess the tax against any of the corporations “whose net income is involved in the consolidated report (sic).” But if the Board were to rely on this language it would become more difficult for it to maintain its position on inclusion of intercompany dividends. That position is based on the theory that combined report allocation does not amount to a disregard of separate corporate entities and it derives its prime support from the *Edison California Stores* decision.\(^6\)

Substitution of Consolidated Return for Combined Report

It may be questioned whether the preservation of this fine distinction between a “combined report” and a true consolidated return is worth the effort. Perhaps the law should be amended to require a consolidated return in all cases of two or more corporations engaged in a unitary business. The Franchise Tax Board would then have clear authority to limit the deduction of losses on liquidation of subsidiaries and also to collect the total California tax from any of the corporations doing business in the state. Of course this would also mean that intercompany dividends would have to be eliminated, and quite possibly this would result in a considerable loss of revenue to the state. If so, it could be recouped by repealing section 24402 or by replacing it with a flat-rate deduction of dividends paid by one corporation to another,

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\(^6\) 30 Cal. 2d 472, 183 P.2d 16 (1947).

\(^7\) See Text at notes 23-26, 32, *supra.*
such as the 85 per cent provision in the federal law.\footnote{INT. REV. CODE of 1954 §§ 243-247.}

Such a change in the statute would create a few problems but they seem much more manageable than the problems that would be solved. Corporations joining and leaving the affiliated group could not be handled so easily as under the federal law because of the commencing-corporation and dissolving-corporation provisions in the California law (which are part of the impedimenta of the pre-payment feature of the California law).\footnote{CAL. REV. & T.C. §§ 23222, 23332.} An intrastate apportionment might still be necessary in such cases.

A constitutional objection might also be suggested if the operations of corporations not doing business in California are required to be included in a consolidated return. A consolidated return is generally regarded as a return being filed jointly by all of the corporations in the affiliated group. Since a state cannot compel the filing of a return by a corporation not present in the state, it might be suggested that the state cannot compel such a corporation to join with other corporations in the filing of a joint return. However, a state does have the right to levy a tax on or measured by income derived from or attributable to sources within its boundaries; and if the requirement of a consolidated return is confined to instances where the affiliated group is carrying on a unitary business within and without the state, then the state is simply exercising this right.\footnote{Bay Cities Transportation Company v. Johnson, 8 Cal. 2d 706, 68 P.2d 710 (1937), holding that corporations not doing business in California could not be included in a consolidated return, was not decided on constitutional grounds rather as an interpretation of a statutory provision (repealed in 1935) which permitted consolidated returns in the same manner as under the federal law. A properly drafted provision, making the existence of a unitary business a condition precedent, should avoid this result.} If a sound method of apportionment is used, no income from extra-territorial sources will be included in the tax base and there can be no objection on constitutional grounds.