California Franchise Tax Board
FTB Notice No. 92-4

Re: Revised Diverse Business Audit Guidelines August 18, 1992

Revised audit guidelines with respect to the unitary combination of diverse businesses have been provided to Franchise Tax Board Compliance Division staff. In response to a number of requests for copies, the revised guidelines are attached.

FRANCHISE TAX BOARD
DIVERSE BUSINESS AUDIT GUIDELINES
AUGUST 1992

In October 1990, the Franchise Tax Board audit staff was advised to conform their use of Reg. § 25120(b) with the SBE's decision in Appeal of Sierra Production Service, Inc., 90-SBE-010. The guidelines issued at that time have now been updated to take into account the California Court of Appeal decisions in Mole-Richardson v. Franchise Tax Board, 220 Cal.App.3d 889 (2nd Dist. 1990) (review denied November 6, 1990), Dental Insurance Consultants v. Franchise Tax Board, 1 Cal.App.4th 343 (1st Dist. 1991) (review denied January 30, 1992), and Tenneco West, Inc. v. Franchise Tax Board, 234 Cal.App.3d 1510 (4th Dist. 1991) (review denied January 30, 1992). The revised guidelines are as follows:

1. There is no unique test for evaluating unity in diverse business cases. Unity can be established under any one of the judicially acceptable tests (Butler Bros., Edison California Stores, Container, etc.), and cannot be denied merely because another of those tests does not simultaneously apply.

The fundamental issue is whether or not the activities carried on within and without the state (or among different business segments) are sufficiently related to justify combination in a common apportionment scheme. "Unitary" segments may be aggregated for purposes of determining by formula, rather than by separate accounting, the amount of income attributable to this state.

The judicially acceptable tests for unity have been variously phrased by the courts as the "three unities", "contribution or dependency", and "flow of value" as evidenced by contributions to income resulting from functional integration, central management and economies of scale. Also, the basic test found in Reg. § 25120(b), "if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole", has been interpreted as consistent with the judicially established tests. All of these apply with equal force, and a finding that any one of them has been met will result in a finding that the otherwise distinct activities are unitary.

2. Functional (i.e., operational) integration is not a requisite test for unity. Diverse businesses are not presumptively nonunitary, and they do not require a higher burden of proof of unity.

The position that strong central management and centralized departments cannot result in unity of diverse businesses in the absence of operational integration has been rejected by the courts. In Mole-Richardson and Dental Insurance Consultants, the courts found that unity was evidenced primarily by the involvement of central managers and the presence of some centralized departments. Intercompany sales, sharing of technology, etc., were not in evidence. Consequently, it is concluded that unity cannot be denied solely because of a lack of operational integration.

3. A unitary analysis must be based on evidence. Descriptive terms or labels, even those which evolve from language found in important unitary decisions, are of little significance.

While it may be useful to contrast the facts from one case to another, no two cases will ever be identical. The resolution of any given case will ultimately turn on whether or not the evidence in that case indicates that any of the judicially accepted tests have been met. Care must be taken not to confuse descriptive fact pattern terms or labels, even those which evolve from the language found in important unitary decisions (e.g., "functional integration"), with the legal tests for unity. For example, the fact that "functionally integrated" businesses may be found unitary does not raise "functional integration" to the level of a requisite test to be used in other cases: non-functionally integrated businesses may also be unitary. Similarly, when considering "strong central management", "same type of business", "holding company", and any other term descriptive of a particular fact pattern, bear in mind that resolution of the unitary issue will turn on an application of the established tests to the unique facts in evidence in each case.

4. The Reg. § 25120(b) presumptions of unity are important, but not conclusive, considerations in determining unity.

The SBE decision in Sierra explained the procedural aspects of the presumptions found in Reg. § 25120(b). With respect to the (b)(3) presumption, when a taxpayer (or the department) establishes, by specific, concrete evidence, both strong, centralized management and the requisite centralized departments, the business is presumed to be unitary. That presumption may be rebutted, but the burden is on the opposing party to demonstrate "concrete evidence sufficient to support a finding that a single integrated economic unit did not exist." It is not enough to merely deny combination because a taxpayer fails to demonstrate "functional integration". If the presumption is met, it can only be overcome with evidence that the activities are not unitary.

According to Sierra, the presumption, once rebutted, "disappears". The burden then shifts back to the party seeking combination, not to demonstrate strong centralized management or centralized departments, but to provide evidence to compel a factual determination that the operations constituted a single, unitary business.

The use of Reg. § 25120(b)(3) as an evidentiary presumption was not addressed in any of the recent judicial decisions. Instead, the courts dealt directly with the question of whether or not the business segments were actually unitary.

The audit staff will continue to follow the SBE's procedural admonitions, but will primarily be concerned with the fundamental issue of whether or not the segments under review were actually unitary.

5. The Court of Appeal decisions in Mole, Tenneco West and Dental Insurance Consultants are controlling of the diverse business issue.

The SBE denied unitary status to Mole and Dental Insurance Consultants. On the same facts, the courts found these taxpayers to have been unitary, even in the absence of operational integration. Hopefully, some reconciliation of these divergent lines of authority will become evident in the near future. In the interim, to the extent that SBE decisions are not in accord with these court cases, they should not be relied upon.