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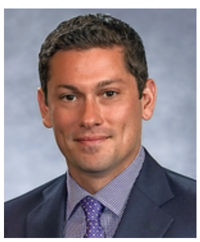
New York State recently made a change to combined reporting for unitary businesses, but it has yet to decide what actually constitutes a unitary business. In this article, Jennifer Goldstein and Jack Trachtenberg of Reed Smith discuss how that might be determined and the potential consequences if the definition continues to remain unclear.

Combined Reporting in New York: The Coming Battles Over the Unitary Business Principle



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Introduction

New York recently adopted a unitary combined reporting regime. The state has not, however, adopted a clear definition or test for what constitutes a unitary business. This article will explore what it means to be unitary in New York, the variety of tests that are available to determine a unitary business, and the battles that taxpayers are likely to face if the state does not better develop the contours of the unitary business principle in New York.

Background: New York's Combination Laws

Pre-2007. Historically, New York State has been a separate company filing state for purposes of the franchise tax imposed on general business corporations un-

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der Article 9-A of the Tax Law (the ''Franchise Tax'').[1] For tax years beginning in or before 2006, the New York State Department of Taxation and Finance (the ''department'') could permit or require a group of corporations to file on a combined basis for Franchise Tax purposes if the: (1) stock ownership, (2) unitary business and (3) distortion of income tests were met.[2] The distortion test looked to whether reporting on a separate basis distorted the taxpayer's activities, business, income or capital in New York.[3] Under the regulations in effect at the time, distortion was presumed to exist when there were ''substantial intercorporate transactions'' among the group of corporations.[4] This presumption of distortion was, however, rebuttable.[5]

Where the presumption of distortion was established, taxpayers seeking to overcome forced combination often looked to rebut the presumption by establishing that the intercorporate transactions in question were engaged in at arm's length. This frequently resulted in prolonged audit controversies, litigation, and an inevitable ''battle of the experts'' regarding the appropriate transfer pricing of the transactions. Given the highly fact-sensitive nature of the litigation, the case law failed to establish clear guidance for taxpayers. As a result, the issue of distortion became increasingly controversial over time.

2007 – 2014. In 2007, the Tax Law was amended, ostensibly to simplify New York's Franchise Tax combined reporting regime and reduce future litigation on the issue.[6] Under the new law, which was effective for tax years beginning on or after Jan. 1, 2007, corporations that met the stock ownership and unitary business tests—and that had substantial intercorporate transactions—were *required* to report on a combined basis (regardless of the transfer price for the intercorporate transactions).[7] In other words, the existence of substantial intercorporate transactions among related corporations no longer created a presumption of distortion that could be rebutted.

Following the law change, the department quickly released a Technical Service Bureau Memorandum (a ''TSB-M'') in an effort to clarify numerous questions arising under the new law.[8] A second TSB-M was released approximately eight months later, superseding the previously released memorandum, containing a new interpretation of the law.[9] Nearly four years later, the department passed regulations formally interpreting the new statutory provisions. The regulations, however, contained some differences from the previously released TSB-Ms.

Rather than achieving the goal of reducing audit controversies and litigation, the 2007 legislation (and subsequent administrative and regulatory guidance) simply shifted the focus of dispute. Taxpayers and the department began to argue about what activities and transactions should be included in the calculation of substantial intercorporate transactions, as well as how transactions between multiple entities would affect the combined group. Additionally, taxpayers and the department continued to disagree over the application of the department's discretionary authority to permit or require combined reporting, regardless of the existence of substantial intercorporate transactions.[10] Taxpayers and the department also began to give more attention to the unitary business test, which depending on the result desired, provided an alternative basis to argue for or against combination.[11]

Post-2014. New York's combined reporting regime changed dramatically as a result of the 2014-2015 New York State Budget (the ''Tax Reform Legislation'').[12] Effective tax years beginning on or after Jan. 1, 2015, the filing of a combined Franchise Tax return is now generally required in New York for commonly owned or controlled corporations that are engaged in a unitary business.[13] The presence or lack of substantial intercorporate transactions or distortion has been entirely eliminated from the analysis. Therefore, the renewed focus on the unitary business principle that we saw as a result of the 2007 legislation will undoubtably become even more pronounced in the future.

What Does It Mean to Be ''Unitary'' in New York?

Some states that require unitary combined reporting have adopted statutory definitions or tests for determining the existence of a unitary business.[14] New York is not one of those states. The question, therefore, is what

[1] While this article discusses combined reporting and the unitary business principle under Article 9-A of the New York Tax Law, similar issues exist under New York City's corporate tax system, which was recently amended to adopt a unitary combined reporting regime similar to that in effect for New York State for tax years beginning on or after Jan. 1, 2015. In general, references in this article to combined reporting are to unitary combined reporting as opposed to consolidated or affiliated group reporting and nexus combined reporting.

[2] *See* e.g., *Matter of Sherwin-Williams Company*, Tax Appeals Trib. (June 5, 2003), *aff'd* at *Sherwin-Williams Company v. Tax Appeals Tribunal*, 784 N.Y.S.2d 178 (3d. Dep't 2004).

[3] *See id.* (citing 20 NYCRR §6-2.3(a) (former)).

[4] 20 NYCRR §6-2.3(a) (former). The substantial intercorporate transaction requirement was met where 50 percent or more of a corporation's receipts or expenses were from one or more qualified activities described in the regulations. *Id.* at §6-2.3(c).

[5] *See Matter of Silver King Broadcasting of N.J.*, Tax Appeals Trib. (May 9, 1996); *Matter of Standard Mfg. Co.*, Tax Appeals Trib. (Feb. 6, 1992).

[6] Ch. 60 (S. 2110, A. 4310), Laws 2007, enacted April 9, 2007.

[7] N.Y. Tax Law §211(4)(a).

[8] TSB-M-07(6)C (June 25, 2007).

[9] TSB-M-08(2)C (Mar. 3, 2008).

[10] *See Matter of Knowledge Learning Corporation and Kindercare Learning Centers*, Tax Appeals Trib. (Sept. 18, 2014).

[11] *See In the Matter of IT USA, Inc.*, No. 823780 & 823871 (N.Y. Tax Appeals Tribunal, 2014); *In re Sungard Capital Corp. and Subsidiaries,* DTA Nos. 823631, 823632, 823680, 824167 & 824253 (N.Y. Div. Tax. App. 2014).

[12] 2014-2015 New York State Budget, SB 6359-D and AB 8559-D.

[13] N.Y. Tax Law §210-C(2)(a).

[14] *See e.g.*, 35 ILCS §1501(a)(27)(A); Mass. Gen. L. §32B; Me. Rev. Stat. Ann. §5102(10-A); MCL §206.611(6); Or. Rev. Stat. §317.705(3)(b); Colo. Rev. Stat. §39-22-303(11)(a). The helpfulness of these statutory definitions varies. For example, the Massachusetts statute provides a vague definition of ''unitary business'' and proceeds to state that the term ''shall be construed to the broadest extent permitted under the United States Constitution.''

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does it mean to be unitary for New York State Franchise Tax purposes?

The regulations in effect for periods prior to New York's adoption of unitary combined reporting may provide some guidance. Under the regulations, consideration must be given to whether the activities a corporation engages in are related to the activities of the other corporations in the group. These activities include:

- manufacturing or acquiring goods or property or performing services for other corporations in the group,
- selling goods acquired from other corporations in the group or
- financing sales of other corporations in the group.[15]

The department must also consider whether the corporation is engaged in the same or related lines of business as the other corporation in the group. This includes:

- manufacturing or selling similar products,
- performing similar services or
- performing services for the same customers.[16]

This regulatory guidance is somewhat vague and seemingly incomplete in light of the unitary business criteria and limitations established by the U.S. Supreme Court.[17] Additionally, it seems unlikely that these regulations are applicable (or even remain in effect) under the Tax Reform Legislation, which has created an entirely new statutory framework. For instance, the regulation that addresses the determination of a unitary relationship also provides guidance regarding the application of the substantial incorporate transaction test—a principle that is no longer included in Tax Law.

Despite the lack of clear standards defining a unitary business, the department has yet to adopt updated regulations or administrative guidance addressing the issue. In fact, based on our discussions with department officials, it appears there may be no current plans to do so. Rather, the department seemingly views the unitary business test as a fact-specific inquiry that should be decided on a case-by-case basis using the standards set forth in applicable state and federal case law. The department has not, however, made it clear whether it intends to follow prior case law in New York or argue for new jurisprudence under the new combined reporting regime.

While the unitary business test undoubtedly presents a fact-specific inquiry, both the department and taxpayers would benefit from a clear test or set of standards to guide that inquiry. In the absence of an agreed-upon test or set of standards, there will be disagreement as to how the facts of a particular case should be interpreted because there will be no clear test against which the facts may be applied or measured.

The lack of a clear test for determining the existence of a unitary business is troubling because the inevitable result will be for the department and taxpayers to selectively use the facts of a given case as tools to argue for a desired outcome. As in other areas of ambiguity in the Tax Law, this creates the danger that the department will be viewed—correctly or not—as making audit determinations that are based largely, if not entirely, on revenue considerations.

What Unitary Business Tests Could New York Apply?

In the absence of a statutory or regulatory definition, the department could assert any number of tests to determine the existence of a unitary business. There are a few generally accepted tests to be considered.

The first two were born from California's efforts—as the first state to adopt unitary combined reporting—to define the unitary business principle. In *Butler Brothers v. McColgan*,[18] the California Supreme Court addressed the unitary business principle for the first time.[19] In a decision that was affirmed by the United States Supreme Court, the court held that the unitary nature of a taxpayer's business was established based on three unities: (1) unity of ownership; (2) unity of operation; and (3) unity of use. In the *Butler* case, the "three unities" were met because there was common ownership; centralized purchasing, advertising, accounting and management divisions; and a centralized executive force.

In *Edison California Stores Inc. v. McColgan*,[20] the California Supreme Court enunciated another unitary business test. In establishing what is now commonly called the "contribution and dependency test," the court stated that a unitary business relationship could be established when "business done within the state is dependent upon or contributes to the operation of the business without the state."[21] Finding that the contribution and dependency test was met, the court held that California was justified in combining and apportioning the income of multiple corporate affiliates, all but one of which was engaged in business entirely outside the state.

The third generally accepted test for determining the existence of a unitary business was established by the U.S. Supreme Court in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont.*[22] In *Mobil Oil Corp.*, the Supreme Court held that the taxpayer's in-state and out-of-state activities were part of a single unitary business because the enterprise was characterized by (1) functional integration, (2) centralization of management and (3) economies of scale.[23] The court explained that in order to prevent taxation as a unitary business, income of related entities must be derived from "unrelated business activity" that constitutes a "discrete business enterprise."[24]

The U.S. Supreme Court has continued to apply the three-factor *Mobil* test when determining whether a unitary business exists.[25] Indeed, in *Container Corp. v. Franchise Tax Bd.*,[26] the Supreme Court stated that the three factors evidence the "sharing or exchange of

[15] 20 NYCRR §6-2.3(e)(1).

[16] *Id.* at §6-2.3(e)(2).

[17] *See Matter of IT USA, Inc.*, Tax Appeals Trib. (Apr. 16, 2014) (noting that the regulations are "in harmony" with the unitary business indicia developed by the Supreme Court).

[18] 17 Cal.2d 664, *aff'd*, 315 U.S. 501 (1942).

[19] *Butler Brothers v. McColgan*, 17 Cal.2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942).

[20] 30 Cal.2d 472, 183 P.2d 21 (1947).

[21] 183 P.2d at 21.

[22] 445 U.S. 425 (1980).

[23] *Id.* at 438.

[24] *Id.* at 439, 442.

[25] *See Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. 207 (1980).

[26] 463 U.S. 159 (1983).

value not capable of precise identification or measurement . . . which renders formula apportionment a reasonable method of taxation.''[27] In other words, the presence of the three factors indicates that there are unquantifiable ''flows of value'' that constitutionally justifies treating a group of corporations as a unitary business.

The three-factor *Mobil* test has become so central to the U.S. Supreme Court's unitary business jurisprudence that the court now considers the three factors to be the ''hallmarks'' of a unitary relationship.[28] Nonetheless, the court has held that there is no single unitary business test, which means the states remain free to adopt their own standards so long as they remain within the confines of the constitutional limitations established by the court. In New York, the Tax Appeals Tribunal stated this explicitly in *Matter of IT USA, Inc.*:

> ''The constitutional prerequisite to an acceptable finding of unitary business is a flow of value between the subject entities (*Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 178, *reh denied* 464 U.S. 909). The Supreme Court has further stated that while the indicia of a unitary business are functional integration, centralization of management and economics of scale, there is no single test for determining whether a unitary business exists; rather, there are a wide range of constitutionally acceptable variations of the unitary business theme (*Container Corp. of America v. Franchise Tax Board*, *supra*).''[29]

The lack of a clear unitary business test in New York was most recently illustrated in *Matter of SunGard Capital Corp. and Subsidiaries*.[30] In *SunGard*, the Tax Appeals Tribunal noted that ''a unitary business analysis necessarily depends on the facts of each case'' and deployed a variety of tests and standards to determine whether combination was appropriate. The Tribunal looked for evidence of flows of value between the entities in question and whether the three Mobil factors were present. It also took account of the federal unitary business doctrine and the department's regulations. Accordingly, the Tribunal analyzed whether transactions were undertaken at arm's length, whether the proposed combined group's entities were engaged in the same or related lines of business, and whether the different business segments complimented each other (e.g., by providing products, expertise or cross-selling opportunities).

It seems, therefore, that the department is free to assert any of the acceptable unitary business tests it wishes (or an entirely new test) as it embarks on its duty to administer the state's unitary combined reporting regime. This is disconcerting since the generally acceptable tests are not always clear or even entirely in harmony with one another, and could therefore lead to uncertain reporting obligations and differing results on audit. Moreover, the department's proposed case-by-case analysis threatens the same difficulties that taxpayers experienced under New York's prior ''distortion combination'' regime. Indeed, if the experience of taxpayers in New York under the prior regime is any indication of how the unitary business principle will be administered under the new unitary combined reporting regime, taxpayers should brace themselves for what many fear will be ambiguous guidance, uncertain reporting obligations, inconsistent audit treatment and outcome-driven assessments.

[27] *Id.*

[28] *See MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16 (2008).

[29] *Matter of IT USA, Inc.*, Tax Appeals Trib. (Apr. 16, 2014).

[30] Tax Appeals Trib. (May 19, 2014).

Is the Unitary Business Principle The New Battleground in New York?

For years, the primary area of controversy and litigation in the area of combined reporting has been the presence or lack of distortion and substantial intercorporate transactions. Under the pre-2007 regime, the department's auditors routinely sought to combine related corporations where doing so resulted in an assessment of additional tax. This was particularly true where the existence of substantial intercorporate transactions triggered the presumption of distortion.

Following the 2007 law change, which required combination of commonly owned unitary corporations that have substantial intercorporate transactions, the department's auditors continued to seek combination where doing so resulted in an assessment of additional tax. In some cases, however, the focus of the department's auditors seemed to shift. Rather than emphasizing combination, taxpayers increasingly faced audits in which the department sought to decombine (i.e., remove) entities from the combined group. Typically, this occurs when the auditor believes a large loss company can be removed from the group because of a lack of substantial intercorporate transactions, thereby increasing the tax liability of the combined group.

Many taxpayers believe the department's shifts in seeking combination or decombination have been driven largely by revenue considerations. Fueling this concern is the experience of some taxpayers who have seen the department's auditors seek to *combine* a loss company where, despite the loss, doing so results in an increased tax liability for the group because of the loss company's high New York apportionment factors. Similarly, some taxpayers have seen the department seek to decombine a loss company while, for the same audit years, the New York City Department of Finance has sought to combine the loss company (similarly, because of the loss company's high New York City apportionment factors).

The perception that the department has historically administered its combination regime in a revenue-driven manner has many taxpayers concerned about how the new unitary combined reporting requirements will be administered. As we have seen, New York does not have a statutory or regulatory definition or test for what constitutes a unitary business. Nor has the department done anything to reassure taxpayers that it will at least generally follow prior regulatory and judicial guidance regarding the contours of the unitary business principle in New York. Indeed, given the entirely new combined reporting regime and the judicial acknowledgement that there are a ''wide range'' of constitutionally acceptable unitary business tests, the department could seek to apply any number of the unitary business tests discussed in this article or it could even adopt an entirely new test. Most troubling, it could apply different tests to different taxpayers or to the same taxpayer in different tax years.

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Whether the perceptions and concerns of taxpayers are legitimate or not, they are already being reinforced through current audits, the outcomes of which could have a significant tax impact under the new unitary combined reporting regime. For example, at least one taxpayer is facing an attempt by department auditors to decombine a manufacturing entity for tax years prior to Jan. 1, 2015, on the basis that it is not unitary with the group. Historically, it is rare for the department to challenge an entity's unitary status. Yet, curiously, if the department prevails and the alleged lack of a unitary relationship continues into future years, the removal of the manufacturing entity will mean that the combined group will not be entitled to the new 0 percent tax rate in effect for qualified New York manufacturers under the Tax Reform Legislation.

This is just one example of how an unclear test for determining the existence of a unitary business could result in group composition disputes and a perception that auditors will adjust a group's composition to generate more tax. Others could include combining a qualified New York manufacturer in the group to deny it the 0 percent tax rate or combining entities to tax affiliates who would otherwise lack sufficient nexus to be subject to New York's Franchise Tax. A determination as to a combined group may also have an impact on the potential taxation of investment income in light of the restrictive capping of investment income to 8 percent of entire net income.

Conclusion

The department should strongly consider adopting a clear definition and test for determining the existence of a unitary business under New York's new unitary combined reporting regime. Doing so will assist taxpayers in fulfilling their tax filing and payment obligations and will help ensure consistency in the conduct of department audits. Most importantly, however, it would do much to reduce the coming audit controversies and litigation, and would help to remedy the perception that the department's combination audits are driven by a desire to raise revenue. In the meantime, however, taxpayers should consider whether the lack of a clear unitary business test in New York and the availability of a variety of potential tests provide a basis for more favorable reporting positions to be taken under the Tax Reform Legislation.