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ADMINISTRATIVE HEARINGS

STATE OF MINNESOTA

DEPARTMENT OF REVENUE

IN THE MATTER OF THE PROPOSED ADOPTION OF NEW AND AMENDED RULES AND THE REPEAL OF A RULE OF THE DEPARTMENT OF REVENUE RELATING TO THE TAXATION OF A UNITARY BUSINESS AND FORMULA APPORTIONMENT. (13 MCAR SECTIONS 1.6501 TO 1.6503, 1.6004, MINNESOTA INCOME TAX RULE 2019 AND REPEALING RULE 2017(3)).

STATEMENT OF NEED AND REASONABLENESS

This document has been prepared as a verbatim affirmative presentation of the facts necessary to establish the statutory authority, need for and reasonableness of the proposed new and amended rules and repeal of a rule. It is submitted pursuant to 9 MCAR Section 2.104 requiring a Statement of Need and Reasonableness. The Statement of Need and Reasonableness for each rule has been typed separately for ease in understanding and to reduce the cost for a person who is interested only in one rule.

A Notice of Intent to Solicit Outside Opinion regarding income tax rules including corporate income taxes was published in the State Register on January 29, 1979 and again on July 6, 1981. These proposed new and amended rules and repeal of a rule were submitted to those people who contacted us, for their comment on September 7 and on November 19, 1982. Public meetings were held on September 29, 1982 and on December 8, 1982, at which time these rules were discussed with interested people. All interested parties were allowed time to submit comments orally or in writing. Suggestions and comments that were received have been duly considered.

Authority to Adopt Rules

Minn. Stat. Section 290.52 grants the Commissioner statutory authority to promulgate rules concerning the income tax law. Implicit in the authority to establish rules is the ability to amend and repeal rules. The unitary business rules are caused by the law changes made in Laws 1981, Third Special Session, Chapter 2, Article 3, Sections 13-15, and as amended by Laws 1982, Chapter 523, Article 29.

Rule 13 MCAR Section 1.6501 - Definition of Unitary Business.

Statement of Need and Reasonableness

A. The first sentence of this paragraph excludes an S corporation from the definition of a corporation for purposes of a unitary business. In the federal Subchapter S Revision Act of 1982, P.L. 97-354, the designation of a Subchapter S corporation was changed to an S corporation effective for taxable years beginning after December 31, 1982. In order to qualify as an S corporation under federal law, Internal Revenue Code Section 1361 provides that all shareholders must be individuals or, in certain situations, an estate or trust. Minn. Stat. Section 290.9725 provides that if an S corporation has a valid federal election it will be accorded the same treatment for Minnesota purposes. Minn. Stat. Section 290.9726, subd. 1 states that the provisions of Section 290.01, subd. 20 to 20f shall govern the treatment of this income to the shareholder. Minn. Stat. Section 290.01, subd. 20 provides that Minnesota will use federal adjusted gross income as its starting point for the taxation of individuals, estates and trusts. Minnesota taxes all of the income of its resident individuals. Since no provision is made to increase or decrease an individual resident's income if the individual is part of a unitary business, the rule provides that the S corporation would not be a part of a unitary business. The statute does provide modifications for part-year and nonresidents so that Minnesota will tax only their Minnesota income. For federal and Minnesota purposes, the S corporate entity is disregarded and the tax consequences of the operations are passed on directly to the individual shareholders of the S corporation. This is why the term corporation would not include an S corporation for purposes of a unitary business and the combined income approach. The exclusion of an S corporation from unitary tax treatment is reasonable since no provision is made in the law to modify an individual's income.

The second sentence of this paragraph contains the definition for the term United States. The term United States as used in Minn. Stat. Section 290.34, subd. 2 is read broadly by the Department and is considered to include not only all the states but also the District of Columbia and the Commonwealth of Puerto Rico. It also includes any possession of the United States or political subdivision of any of the foregoing. It is the Department's position that since the Commonwealth of Puerto Rico and the possessions of the United States are granted protection by the United States and are governed by the Constitution of the United States, these areas should be included within the definition. These areas are granted substantial benefits by the United States Government. Laws enacted by the Congress and decisions of the U.S. Supreme Court apply to these areas. For these reasons, the Department has included these areas within the definition of United States for purposes of the unitary business concept and the combined income approach.

B. The first sentence of this paragraph defines the unitary business. It is a restatement of the definition contained in Minn. Stat. Section 290.17, subd. 2, clause (4), 2nd paragraph, 2nd sentence. The rule states that more than one corporation must be involved in order to find a unitary business. In addition, those corporations involved in a unitary business must be related through common ownership and the business activities of the corporations must be of mutual benefit, dependent upon or contributory to the activities of one or more of the other corporations in the unitary group. The rule does provide that common ownership, as defined in this rule, must be found before the test of mutual benefit, dependent upon, or contributory to is applied. This is a clarification of the application of the test.

The concept of the unitary business and resulting formula apportionment were developed by the states in order to serve as an expedient and rational means by which to define the income of a multistate business for tax purposes. The

concern that many states have had was that many corporations which were deriving profits from a particular state were able to immunize themselves from tax on those profits by organizing themselves in such a way as to eliminate or substantially reduce their tax liability to that state based on their form of conducting business. The unitary business concept was devised in order to protect each state's tax base on the amount of profit generated by that corporate entity in the state. When applied for corporate income tax purposes, the unitary business concept and combined reporting determine a corporation's tax liability to a state by looking at the entire (unitary) business of which the corporation is a part. That business consists of all units which are engaged in it, whether those units be divisions in the corporation, or corporate affiliates of a multicorporate enterprise. In a state which applies the unitary business concept with combined reporting, substance triumphs over mere form. The unitary business concept enables states to look beyond the immediate corporation to determine the true nature of the operations of a multicorporate business and to tax fairly the income derived from those operations. See, Corrigan, Mobil-izing Interstate Taxation, Tax Notes, October 12, 1981; Dexter, The Unitary Concept in State Taxation of Multistate-Multinational Businesses, 10 Urb. Law. 181 (1978); Chen, State Taxation of Unitary Businesses, 8 Fordham Urb. L.J. 819 (1979-1980).

The Minnesota legislature has enacted specific legislation in order to protect Minnesota's tax base and to fairly tax the operations of multistate and multinational corporations conducting part of their business within Minnesota. The unitary legislation and these rules are written in order to avoid protracted litigation which may otherwise be needed to establish Minnesota's right to utilize the combined income approach under the unitary business concept and to put all corporations on notice that the unitary business concept and combined reporting will be used by the State of Minnesota. It is the Department's

position that these rules on unitary taxation are necessary in order to inform the taxpayer as to the parameters and effects of the unitary business concept and combined reporting to its particular business.

The mutual benefit, dependent upon, or contributory to test was used by Minnesota courts prior to the passage of the new unitary tax law. In Western Auto Supply Company v. Commissioner of Taxation, 71 N.W.2d 797 (1955), the Minnesota Supreme Court stated this test in finding a taxpayer was conducting a unitary business partly within and partly without Minnesota. Western Auto was a Missouri corporation engaged in the retail and wholesale merchandising of automotive parts and accessories on a nationwide basis. During 1947 Western Auto operated 257 retail stores in 30 states. This included eight such stores in Minnesota. All general, executive, and management functions of Western Auto were performed at its home office in Kansas City, Missouri. The centralized purchasing was done by expertly trained personnel whose department was located in Kansas City. All the merchandise sold by Western Auto was purchased from manufacturers and jobbers by the company's central purchasing department and initially shipped from the manufacturing jobbers to warehouses of the taxpayer and from there to company stores, or sold and delivered to the dealer stores. Western Auto, in filing its 1947 Minnesota corporate income tax return, apportioned to Minnesota on the basis of separate accounting. The Commissioner, upon auditing the return for 1947, apportioned Western Auto's income under the statutory three factor formula of property, payroll, and sales. The issue in the case was whether the Commissioner of Taxation was correct in readjusting taxpayer's apportionable income to Minnesota. The Minnesota Supreme Court stated that the test to be applied in determining whether a business is a unitary one is based on whether the operation of the business within the state is dependent upon or contributory to the operation of the business outside the state. The court went on to state that the test of whether a business is

unitary is whether its various parts are interdependent and of mutual benefit so as to form one business unit rather than separate business entities and not whether the operating experience of the parts is the same in all places. The court stated that the profits that Western Auto realized through centralized purchasing and administration were not created solely by activities in the state of taxpayer's home office or in states where its warehouses were located. It was created by the operation of the entire business unit, through the coordinated and standardized activity of numerous stores throughout the country which made possible the central purchasing, the central management, the warehousing as carried on, and the advertising methods adopted. The Minnesota stores contributed in part to make all this possible, and the multiple formula methods simply allocated a fair share of the profits to Minnesota. Western Auto was found to be a unitary business under this test.

The second sentence of this paragraph restates the presumption of a unitary business where the three unities exist as provided in Minn. Stat. Section 290.17, subd. 2, clause (4), 2nd paragraph, 3rd sentence. The three unities test (unity of ownership, unity of operation and unity of use) has been utilized by the courts for several decades. The Supreme Court of the United States in Butler Brothers v. McColgan, 315 U.S. 501 (1942), utilized the three unities test in determining that the taxpayer was conducting a unitary business. Butler Brothers was an Illinois corporation engaged in the wholesale dry goods and merchandising business. It operated seven wholesale stores in seven states, including one in California. Each of the seven locations served as a separate territory. Each location had its own sales persons, handled its own collections and credit arrangements, and kept its own accounts. All of the sales in California were handled by a San Francisco office. All purchases made by the San Francisco office came from the company's home office in Chicago.

Charges for the goods were made to each location at cost plus transportation expenses. Operating and advertising costs by the central purchasing division were allocated among the several wholesale stores. Although the business as a whole realized a profit, the California operation showed a loss. This loss was computed by the taxpayer using the separate accounting method. California treated Butler Brothers as a unitary business and used a formula to allocate a portion of taxpayer's overall profit to the state. The United States Supreme Court found that Butler Brothers was conducting a unitary business. The critical factor in the court's holding was Butler Brothers' use of a central purchasing division. This system enabled it to obtain lower prices than would be possible from the individual branches. The court noted that this mode of operation alone would indicate that the branches' functions were closely integrated. The savings afforded by the lower purchasing prices were reflected in the lower cost to each branch and undoubtedly contributed to the net overall profit of the business.

In determining whether a presumption exists that taxpayer is conducting a unitary business based on the three unities test, the focus of the determination is whether, as a result of the unitary characteristics, the income (or loss) of the combined operations are materially different from what would have been in the absence of those unitary characteristics.

The rule sets out in the second sentence of paragraph B. what evidence or characteristics will be looked at in order to determine whether each of the three unities exist, thereby creating the presumption of a unitary business. The question of whether or not a business is unitary and what constitutes the income of that unitary business involves complex factual determinations concerning all phases of the operation of the business, particularly that data pertaining to the overall management of the business and interrelationship with

the various operating branches or departments of that business. Many of these characteristics or indicia of one of the three unities have been incorporated in numerous court cases over the years. Probably one of the most significant court cases is Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (1947). In Edison California Stores, a multistate retail shoe business was operated through a Delaware parent corporation with its headquarters in St. Louis. The corporation was comprised of 15 wholly owned subsidiary corporations, each operating in its state of incorporation. The parent provided centralized management, purchasing, advertising, and other centralized administrative functions. The home office determined operating policies for the entire affiliated group and conducted the principal accounting work for all subsidiaries. Goods purchased by the central purchasing division were shipped to the various stores operated by the subsidiaries, which were charged with the cost and a portion of the general overhead expenses. Each subsidiary operated solely within the geographical confines of its particular state. The California Tax Commission regarded the entire business, comprising the parent and all the subsidiaries, as a unitary business. The taxpayer objected on the grounds that the unitary rule did not apply to separate corporate entities. The court rejected this argument and held that the corporate veil of each corporation could not cloak the existence of an integrated multistate unitary business enterprise. In finding a unitary business, the California Supreme Court stated:

> In the present case all the elements of a unitary business are present--unity of ownership, unity of operation by centralized purchasing, management, advertising and accounting, and unity of use, in the centralized executive force and general system of operation. The business of the parent and all of its subsidiaries is owned and managed under one centralized system, to the same extent as in the Butler Brothers case and other cases considered therein. Thus, the business is unitary regardless of the fact that in the Butler Brothers case there was but one corporation involved . . . and that in the present case there is a parent corporation owning and controlling as units of one system 15 different branches organized as corporations . . . . At page 21.

The third sentence in paragraph B. states that not all of the examples are needed to show unity of operation or unity of use. The Department wishes to

stress that the determination of whether a business is part of a unitary business is based on the particular facts in each case. The factual determination is undertaken in order to determine whether sufficient facts or indicia exist which evidence the conduct of a unitary business. It is the Department's position that not all of the factors mentioned in the rule which indicate a unitary business are necessary in order to prove that a unitary business exists. The determination of a unitary business must rest upon all the facts of that particular business. Therefore, all of the factors given in the rule are not necessary before a unitary business will be presumed to exist.

Unity of operation is generally shown to exist by showing staff functions such as the centralized advertising, accounting, financing, management, or centralized, group, or committee purchasing. Unity of operation exists where the staff functions for several corporations are being performed by the same group of people and which functions would not occur if the separate corporations were in fact conducting their business as separate entities. Unity of use is evidenced by the same group of people performing line functions such as a centralized executive force. Again, where the line functions are being performed for the different corporations by the same group of management, unity of use has been shown to exist. The same executive force would not be used for separate corporations if those corporations in fact were conducting separate independent businesses.

The rule sets out that in order to establish any of the unities it is not necessary that all factors as enumerated in both the rule and the law exist. It is sufficient that only some of the factors are shown to exist in order to demonstrate that the particular unity does exist for a group of corporations. Other cases that can be examined regarding the definition of a unitary business are: 1. Associated Dry Goods v. Commissioner of Revenue, Minn. Tax Ct. Docket

No. 2457, November 2, 1982; 2. Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. App. 3rd 496 (1970); and 3. Container Corporation of America v. Franchise Tax Board, App. 173 Cal. Rptr. 121 (1981), cert. granted by U.S. Supreme Court on October 6, 1981, argued January 10, 1983.

The fourth sentence of this paragraph contains the test used by the United States Supreme Court in determining the unitary nature of a business. See, Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980); Exxon Corporation v. Wisconsin Department of Revenue, 447 U.S. 207 (1980); ASARCO, Inc. v. Idaho State Tax Commission, 103 S.Ct. 3103 (1982); F. W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico, 102 S.Ct. 3128 (1982).

The test enunciated by the United States Supreme Court to determine whether a unitary business exists is whether functional integration, centralization of management and economies of scale are present. In Mobil, the United States Supreme Court noted that while separate accounting purports to isolate portions of income received in various states, (it) may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Mobil, 100 S.Ct., at 1232. See also, Butler Brothers v. McColgan, 315 U.S., at 508-509.

In ASARCO, the United States Supreme Court noted that "The Mobil Court explicated the limiting 'unitary business' principle by observing that geographic accounting, in purporting to isolate income received in various states, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." ASARCO, S.Ct. at 3109.

The fifth sentence of this paragraph contains examples of functional integration. Examples of functional integration include centralized manufacturing, warehousing, accounting, legal staff, personnel training, financing or centralized, group, or committee purchasing. These examples are generally taken from the United States Supreme Court decision in Woolworth. In Woolworth, the United States Supreme Court looked at the factors of functional integration, centralization of management and economies of scale to determine whether certain subsidiaries were part of Woolworth's unitary business. The Court stated on pages 3135 to 3136 and 3138:

> In Mobil we emphasized, as relevant to the right of a State to tax dividends from foreign subsidiaries, the question whether "contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale." 445 U.S., at 438, 100 S.Ct., at 1232. If such "factors of profitability" arising "from the operation of the business as a whole" exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of value that has no other connection with that State. Ibid. We turn now to consider the extent, if any, to which these factors exist in this case.
>
> [5] There was little functional integration. Woolworth's subsidiaries engaged exclusively in the business of retailing--the purchase of wholesale goods for resale to final consumers. This type of business differs significantly from the "highly integrated business" of locating, processing, and marketing a resource (such as petroleum) that we previously have found to constitute a unitary business. Exxon, 447 U.S., at 224, 100 S.Ct., at 2120. See also id., at 226, 100 S.Ct., at 2121 (describing "a unitary stream of income, of which the income derived from internal transfers of raw materials from exploration and production to refining is a part"); Mobil, 445 U.S., at 428, 100 S.Ct., at 1227. Consistent with this distinction, the evidence in this case is that no phase of any subsidiary's business was integrated with the parent's. With respect to "who makes the decision for seeing to the merchandise, [store] site selection, advertising and accounting control," the undisputed testimony stated "[e]ach subsidiary performs these functions autonomously and independently of the parent company." App. 12. "Each subsidiary has a complete accounting department and a financial staff." Id., at 14. Each had its own outside counsel. App. to Juris. Statement 34. It further appears that Woolworth engaged in no centralized purchasing, manufacturing, or warehousing of merchandise. The parent had no central personnel training school for its foreign subsidiaries. Id., at 34. And each subsidiary was responsible for obtaining its own financing from sources other than the parent. In sum, the record is persuasive that Woolworth's operations were not functionally integrated with its subsidiaries.
>
> We now consider the extent to which there was centralization of management or achievement of other economies of scale. It appears that each subsidiary operated as a distinct business enterprise at the level of fulltime management. With one possible exception, none of the subsidiaries' officers during the year in question was a current or former employee of the parent.

> App. to Juris. Statement 34. The testimony was that the subsidiaries "figure their operations are independent, autonomous." App. 13. Woolworth did not "rotate or train personnel to operate stores in those countries. There is no exchange of personnel." Ibid. There was no "training program that is central to transmit the Woolworth idea of merchandising[,] such as it may be[,] to the foreign subsidiaries." Id., at 15. The subsidiaries "proceed . . . with their own programs, either formal or informal. They develop their own managers and instruct them in their methods of operation." Ibid.
>
> This management decentralization was reflected in the fact that each subsidiary possessed autonomy to determine its own policies respecting its primary activity--retailing . . . .
>
> We conclude, on the basis of undisputed facts, that the four subsidiaries in question are not a part of a unitary business under the principles articulated in Mobil and Exxon, and today reiterated in ASARCO. Except for the type of occasional oversight--with respect to capital structure, major debt, and dividends--that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of these five corporations. Woolworth has proved that its situation differs from that in Exxon, where the corporation's Coordination and Services Management office was found to provide for the asserted unitary business.

The rule demonstrates that functional integration exists where centralized functions are being performed on behalf of all of the corporations in the unitary group by a management group and where said functions would not be performed by the management group if the corporations were in fact conducting separate distinct businesses which were totally unrelated to each other. Centralized management is demonstrated by common officers or directors, exchange of personnel, frequent communication between management of the corporations, or where the parent must approve of major financial decisions. These examples are generally taken from Woolworth. See examples on pages 3137 and 3138. Again, centralized management is demonstrated where a management group is performing functions on behalf of the unitary business which would not be performed if the separate corporations were in fact conducting separate and distinct businesses and were unrelated to each other.

As stated previously, since the determination of a unitary business is mainly a factual determination, it is not necessary that all the examples be shown in

order to establish functional integration or centralized management. Functional integration or centralized management is demonstrated where one or more of the factors listed is shown to exist.

The eighth sentence of this paragraph restates the restriction contained in Minn. Stat. Section 290.34, subd. 2 that combined reporting is limited in scope to domestic unitary groups only. As provided in paragraph A., the term United States includes the District of Columbia, the Commonwealth of Puerto Rico and any other possession of the United States. The rule makes it clear that combined reporting for Minnesota purposes does not mean worldwide reporting.

The ninth sentence of the paragraph provides that the ownership of as much as 100 percent of the stock of another corporation does not in and of itself establish a unitary business. It is essential that an interrelationship which demonstrates a mutual benefit, dependency upon, or contribution to one another be established in order to show that a unitary business exists for Minnesota purposes. Therefore, the mere ownership of the stock of another corporation does not prove unitary absent other indicia of a unitary relationship. This is consistent with the U.S. Supreme Court's decision in Woolworth where Woolworth owned 100 percent of the stock of three of the subsidiaries.

The last sentence in paragraph B. states that if the factors as enumerated in the examples C. through E. are shown to exist then a strong presumption is created that the corporations are conducting a unitary business. Again, it must be noted that not all the factors in the examples must be shown in order to prove a unitary relationship.

C. A horizontal type of business is unitary when the activities of the corporation are basically in the same general line of business and where there is common

ownership, functional integration and economies of scale. This paragraph gives as an example a chain of grocery stores where functional integration, centralized management and economies of scale are demonstrated. The focus of the determination is on the interrelationship between the corporations and on whether each separate corporation is conducting its business in a distinct and separate manner from the other corporations or whether centralized functions are being performed on behalf of all corporations by a management group or an entity on behalf of the whole group of corporations as a unitary business. The origin of the test of functional integration, centralized management and economies of scale was given under paragraph B. with citations to several United States Supreme Court decisions. Common ownership is provided as a minimal criteria in determining a unitary business. Examples of horizontal unitary businesses are contained in Edison California Stores; Western Auto; Butler Brothers; Associated Dry Goods; Valley Markets, Inc. v. Commissioner of Revenue, Minn. Tax Ct. Docket No. 2772, May 7, 1980; and Maurice L. Rothschild & Company v. Commissioner of Taxation, 270 Minn. 245, 133 N.W.2d 524 (1965).

In Edison California Stores, taxpayer was conducting a multistate horizontally integrated retail shoe business from its headquarters in St. Louis. The corporation was comprised of 15 wholly owned subsidiary corporations, each operating in its state of incorporation. The parent provided centralized management, purchasing, advertising, and other centralized administrative functions. The home office determined operating policies for the entire affiliated group and provided the principal accounting work for all subsidiaries. Goods purchased by the central purchasing division were shipped to the various stores operated by the subsidiaries, which were charged with the cost and a portion of the general overhead expenses. Each subsidiary operated solely within the geographical confines of its particular state. The California Tax Commission regarded the entire business, comprising the parent and all the

subsidiaries, as a unitary business. The taxpayer objected on the grounds that the unitary rule did not apply to separate corporate entities. The Court rejected this argument and held that the corporate veil of each corporation could not cloak the existence of an integrated multistate unitary business. In finding a unitary business, the California Supreme Court stated:

> In the present case all the elements of a unitary business are present--unity of ownership, unity of operation by centralized purchasing, management, advertising and accounting, and unity of use, in the centralized executive force and general system of operation. The business of the parent and all of its subsidiaries is owned and managed under one centralized system, to the same extent as in the Butler Brothers case and other cases considered therein. Thus, the business is unitary regardless of the fact that in the Butler Brothers case there was but one corporation involved . . . and that in the present case there is a parent corporation owning and controlling as units of one system 15 different branches organized as corporations . . . . At page 21.

In Western Auto, the Minnesota Supreme Court found that taxpayer was conducting a horizontally integrated unitary business partly within and partly without Minnesota. Western Auto was a Missouri corporation engaged in the retail and wholesale merchandising of automotive parts and accessories on a nationwide basis. During 1947 Western Auto operated 257 retail stores in 30 states. This included eight such stores in Minnesota. All general, executive, and management functions of Western Auto were performed at its home office in Kansas City, Missouri. The centralized purchasing was done by expertly trained personnel whose department was located in Kansas City. All the merchandise sold by Western Auto was purchased from manufacturers and jobbers by the company's central purchasing department and initially shipped from the manufacturing jobbers to warehouses of the taxpayer and from there to company stores, or sold and delivered to the dealer stores. Western Auto, in filing its 1947 Minnesota corporate income tax return, apportioned to Minnesota on the basis of separate accounting. The Commissioner, upon auditing the return for 1947, apportioned Western Auto's income under the statutory three factor formula of property, payroll, and sales. The issue in the case was whether the Commissioner of Taxation was correct in readjusting taxpayer's apportionable income to

Minnesota. The Court stated that the profits that Western Auto realized through centralized purchasing and administration were not created solely by activities in the state of taxpayer's home office or in states where its warehouses were located. It was created by the operation of the entire business unit, through the coordinated and standardized activity of numerous stores throughout the country which made possible the central purchasing, the central management, the warehousing as carried on, and the advertising methods adopted. The Minnesota stores contributed in part to make all this possible, and the multiple formula methods simply allocated a fair share of the profits to Minnesota. Western Auto was found to be a horizontally integrated unitary business.

In Butler Brothers, taxpayer was found to be conducting a unitary business based on horizontal integration and a centralization of management and purchasing. As noted earlier, Butler Brothers was an Illinois corporation engaged in the wholesale dry goods and merchandising business. It operated seven wholesale stores in seven states, including one in California. Each of the seven locations served as a separate territory. Each location had its own sales persons, handled its own collections and credit arrangements, and kept its own accounts. All of the sales in California were handled by a San Francisco office. All purchases made by the San Francisco office came from the company's home office in Chicago. Charges for the goods were made to each location at cost plus transportation expenses. Operating and advertising costs by the central purchasing division were allocated among the several wholesale stores. Although the business as a whole realized a profit, the California operation showed a loss. This loss was computed by the taxpayer using the separate accounting method. California treated Butler Brothers as a unitary business and used a formula to allocate a portion of taxpayer's overall profit to the state. The United States Supreme Court found that Butler Brothers was conducting a unitary business. The critical factor in the court's holding was Butler

Brothers' use of a central purchasing division. This system enabled it to obtain lower prices than would be possible or the individual branches. The Court noted that this mode of operation alone would indicate that the branches' functions were closely integrated. The savings afforded by the lower purchasing prices were reflected in the lower cost to each branch and undoubtedly contributed to the net overall profit of the business. Butler Brothers was functionally integrated and exhibited economies of scale. Butler Brothers was found to be a unitary business.

In Associated Dry Goods, taxpayer was found to be conducting a unitary business by the Minnesota Tax Court. Associated Dry Goods was a Virginia corporation that owned and operated 19 retail store divisions throughout the United States. In Minnesota, it operated a Powers division with seven stores in the Twin Cities metropolitan area. The Commissioner of Revenue considered Associated a unitary business that was horizontally integrated. The Department apportioned Associated's net taxable income to Minnesota by applying a three-factor statutory formula. Associated argued that it should be allowed to report its income to Minnesota on a separate accounting basis. In finding that Associated was conducting a unitary business, the Tax Court in its finding of facts pointed out that Associated's headquarters staff exercised overall control of store operations. There was exchange of key personnel and information within the unitary business. All of Associated's stores were financially interdependent. All borrowing was based on the combined assets of the entire unitary business. Associated's Market Research Division performed research for all of the divisions within the unitary group. Insurance policies were handled centrally by Associated for all the divisions. Associated had a common pension plan. The Minnesota Tax Court held that based on these facts, Associated was conducting a unitary business partly within and partly without Minnesota.

In Valley Markets, the Minnesota Tax Court found taxpayer was conducting a unitary business. Valley Markets was a North Dakota corporation doing business in Minnesota and North Dakota. Valley Market owned and operated a chain of four supermarket food stores. Valley Market argued that it was conducting two separate businesses, one wholly in Minnesota and the other wholly in North Dakota, and that its income from these two businesses should be apportioned by separate accounting. In determining that Valley Market was indeed conducting a unitary business, the Court pointed to the fact that the board of directors and corporate officers exercised centralized management control over the entire corporation. Moreover, there was but one corporate manager exercising centralized control over the ordinary and usual business operations of the entire corporation. Valley Market's centralized management exercised direct business control over numerous areas having to do with all four stores. For example, basic employee policies such as wages, terms of employment, promises of vacation time, were set for the entire corporation by the central management. The payroll was centrally computerized and the board of directors and corporate officers also set up a single profit sharing plan for all four stores, administered by a North Dakota bank. Insurance for all four stores was purchased in one package by central management from a single insurance agent. All expansion decisions were made solely by the board of directors. Finally, accounting and financial statements for the corporation were done by one accounting firm. The Minnesota Tax Court therefore concluded that Valley Markets was a horizontally integrated unitary business which exhibited strong centralized management and economies of scale.

In the Rothschild case, the taxpayer's business consisted entirely of the operation of six retail stores, three in the Twin Cities area and three in the Chicago area, all selling men's, boys', women's and girls' clothing. Its

officers were equally divided in both localities, the president, vice president and treasurer residing in Chicago, and four vice presidents residing in Minnesota. Each store in Rothschild operated to a large extent independently of the other stores. The Minnesota stores had their own purchasing office, their own merchandise managers and buyers, and their own buying office in New York. Separate decisions were made by each store with respect to quantity and type of merchandise to be purchased, although it could not change any brand name carried without the approval of all the officers. Each store maintained its own accounting records and handled its own accounts receivable and payable and had its own bank account. Each store also handled its own employment and personnel matters. However, the Board of Tax Appeals in Rothschild found, and the Supreme Court affirmed, that frequent consultations between the management of the Chicago and Minnesota stores were held concerning fast-moving items and overall policy; that slow-moving merchandise in one store or area would occasionally be shipped to other stores for possible better and faster disposition; that although many lines of merchandise carried in the Chicago stores differed from those carried in the Minnesota stores, the basic lines in men's and women's clothing and in men's shoes were the same; that because of this, price concessions resulted due to volume purchases and there was faster service on reorders and greater advertising allowances by the manufacturer. Based on these facts, the Minnesota Supreme Court found that Pothschild was conducting a unitary business partly within and partly without Minnesota.

D. This paragraph defines a unitary business as one which is vertically integrated and which is engaged in a vertically structured enterprise. Again, the focus is on the interrelationship between the corporations and whether there are any benefits or contributions being made by one or more of the corporations in the unitary group to one or more other corporations in the unitary group. The paragraph demonstrates a flow of goods from the exploration and mining of the copper as a raw material to the smelting, refining and eventual fabrication of

the refined copper into a finished product. The Department relies on the United States Supreme Court decisions in Mobil; Exxon; Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920); and Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924) as its authority in demonstrating a vertically integrated unitary business. The paragraph shows a vertically structured enterprise in which the Mobil and Exxon tests of functional integration, centralized management and economies of scale are present.

In Mobil, the United States Supreme Court found that Mobil was engaged in an integrated petroleum business. Mobil was vertically integrated ranging from the exploration for petroleum reserves to the production, refining, transportation, distribution and the eventual sale of petroleum and petroleum products. Mobil's commercial domicile was located in New York at the time the case arose. During the years 1970, 1971, and 1972, Mobil's worldwide operations included $8,544,000.00, $9,176,000.00 and $9,589,000.00 in sales in Vermont; and it filed returns showing $1,082.00, $25.00 and $25.00 in income tax liability. During that period, it received some $739,000,000.00 in dividends from overseas affiliates and from ARAMCO, an American corporation in which it owned a 10 percent interest. Mobil attributed no portion of the dividends to Vermont. It applied the Vermont apportionment formula to only its nondividend income. In two of the years in question, Mobil showed negative nondividend income and paid the minimum $25.00 fee. The Vermont Department of Taxes recalculated Mobil's income by restoring the asserted nonapportionable items to the preapportionment tax base. It determined that Mobil's aggregate tax liability for the three years was $76,418.77, and deficiencies plus interest were assessed accordingly. The Supreme Court stated that the linchpin of apportionability in the field of state taxation is the unitary business principle. 100 S.Ct., at 1232. Mobil did not show, in order to establish that its dividend income was not subject to an apportioned tax in Vermont, that the income was earned in the course of

of activities unrelated to the sale of petroleum products in that state. The Court found that Mobil's foreign activities (the source of the dividend income) was part of Mobil's integrated petroleum enterprise. The dividends reflected profits derived from a functionally integrated enterprise. Vermont was therefore entitled to subject the income to an apportioned tax.

In Exxon, the United States Supreme Court found that Exxon was a vertically integrated petroleum company doing business in several states. The controversy in the Exxon case started in June of 1977 when Exxon (Humble) received a franchise tax assessment for the years 1965-68 in the amount of $316,470.85. Exxon had no exploration, production or refining operations in Wisconsin. Exxon carried on only marketing in the state. Exxon had prepared returns based on accounting methods reflecting only its Wisconsin marketing operation. Exxon used a nationwide uniform credit card system, which was administered out of the national headquarters in Houston. Uniform packaging and brand names were used, and the overall plan for distribution of products was developed in Houston. Wisconsin assessed the taxes on Exxon as a single unitary business and applied its three factor formula excluding only that income from the sale of crude oil and gas at the wellhead to third parties. The Wisconsin Supreme Court held that taxpayer's Wisconsin marketing operations were an integral part of one unitary business and that therefore its total corporate income was subject to the statutory apportionment formula. The Wisconsin Supreme Court concluded that the test for what constituted a unitary business was whether or not 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. Reviewing the organizational structure and business operations' effects, the Court reasoned that Exxon's production and refining functions were dependent upon its marketing operations to provide an outlet for its products, and Wisconsin was part of that marketing system. In a high capital investment industry

such as the petroleum industry, the Court found, the existence of a stable marketing system was important for the full utilization of refining capacity. The U.S. Supreme Court affirmed the Wisconsin Supreme Court's decision. The United States Supreme Court found that Exxon's marketing operation in Wisconsin was an integral part of Exxon's unitary business. The Court stated that the important link among the three main operating departments of appellant was stated most clearly in the testimony of an Exxon senior vice president. This official testified that:

> [I]n any industry which is highly capital intensive, such as the petroleum industry, the fixed operating costs are highly relative to total operating costs, and for this reason the profitability of such an industry is very sensitive and directly related to the full utilization of the capacity of the facilities.
>
> So, in the case of the petroleum industry it is--where you have high capital investments in refineries, the existence of an assured supply of raw materials and crude is important and the assured and stable outlet for products is important, and therefore when there are--when these segments are under a single corporate entity, it provides for some assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may occur from time to time.
>
> [T]he placing individual segments under one corporate entity does provide greater profits stability for the reason that . . . nonparallel and nonmutual economic factors which may affect one department may be offset by the factors existing in another department. App. 224-225. 100 S.Ct., at 2121.

The Court went on to find that there is indeed a unitary stream of income, of which the income from internal transfers of raw materials from exploration and production to refining was a part. Exxon was conducting a vertically integrated unitary business.

E. A unitary business may be established by showing that strong centralized management exists among the individual separate corporations and that strong centralized management is dictating the major policies of each corporation respecting its primary business activities. As the rule states, strong centralized management is evidenced by such functions as financing, advertising, research, or purchasing. The focus of the determination is on the interrelationship between the separate corporations to determine whether strong centralized management exists which is dictating the major business decisions and

activities of the separate corporations and which said corporations would not be subject to if they were in fact conducting separate distinct businesses independent of any outside control. Strong centralized management cannot be shown by simply showing that the requisite ownership percentage exists. As stated earlier, mere ownership alone is not sufficient to prove a unitary business. Other indicia of a unitary business must be demonstrated before a unitary business can be found to exist, such as strong centralized management. Strong centralized management is not shown where a mere incidental economic benefit accrues to a group of corporations because such ownership improves its financial position alone. As the example sets out, strong centralized management authority must be exercised in order for a unitary business to exist based on strong centralized management alone. See, Exxon; Mobil; ASARCO; Woolworth; Container Corporation of America v. Franchise Tax Board, 173 Cal. Rptr. 121 (1981); Associated Dry Goods; Butler Brothers.

In Exxon on pages 2120 and 2121, the United States Supreme Court emphasized the importance of centralized management when it stated:

> We agree with the Wisconsin Supreme Court that Exxon is such a unitary business and that Exxon has not carried its burden of showing that its functional departments are "discrete business enterprises" whose income is beyond the apportionment statute of the State. While Exxon may treat its operational departments as independent profit centers, it is nonetheless true that this case involves a highly integrated business which benefits from an umbrella of centralized management and controlled interaction.
>
> As has already been noted, Exxon's Coordination and Service Management provided many essential corporate services for the entire company, including the coordination of the refining and other operational functions "to obtain an optimum short range operating program." App. 189. Many of the items sold by appellant in Wisconsin were obtained through a centralized purchasing office in Houston whose obvious purpose was to increase overall corporate profits through bulk purchases and efficient allocation of supplies among retailers. Cf. Butler Brothers v. McColgan, 315 U.S., at 508, 62 S.Ct. at 705 ("the operation of the central buying division alone demonstrates that functionally the various branches are closely integrated").

The concept of centralized management was discussed in greater detail by the United States Supreme Court in Woolworth at pages 3135 through 3137 where it stated:

> In Mobil we emphasized, as relevant to the right of a State to tax dividends from foreign subsidiaries, the question whether "contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale." 445 U.S., at 438. If such "factors of profitability" arising "from the operation of the business as a whole" exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of value that has no other connection with that State. Ibid. We turn now to consider the extent, if any, to which these factors exist in this case . . . .
>
> We now consider the extent to which there was centralization of management or achievement of other economies of scale. It appears that each subsidiary operated as a distinct business enterprise at the level of fulltime management. With one possible exception, none of the subsidiaries' officers during the year in question was a current or former employee of the parent. App. to Juris. Statement 34. The testimony was that the subsidiaries "figure their operations are independent, autonomous." App. 13. Woolworth did not "rotate or train personnel to operate stores in those countries. There is no exchange of personnel." Ibid. There was no "training program that is central to transmit the Woolworth idea of merchandising[,] such as it may be[,] to the foreign subsidiaries." Id., at 15. The subsidiaries "proceed . . . with their own programs, either formal or informal. They develop their own managers and instruct them in their methods of operation." Ibid.
>
> This management decentralization was reflected in the fact that each subsidiary possessed autonomy to determine its own policies respecting its primary activity--retailing . . . .
>
> Importantly, the Department's hearing officer found that Woolworth had "no department or section, as such, devoted to overseeing the foreign subsidiary operations." App. to Juris. Statement 34. Neither the parent corporation nor any of the subsidiaries consolidates its tax return with any of the other companies. App. 37-38. The tax manager for Woolworth stated that he did not review the subsidiaries' tax returns or consult with them on decisions affecting taxes. Id., at 14. There was no "policy of the parent that all of the managers of all the operations get together periodically to discuss the overall Woolworth operations." Id., at 35.

The Court concluded that based on the undisputed facts, that the four subsidiaries in question were not part of Woolworth's unitary business. The Court on page 3138 distinguished Woolworth and Exxon and stated that:

> Woolworth has proved that its situation differs from that in Exxon, where the corporation's Coordination and Services Management office was found to provide for the asserted unitary business

> "long-range planning for the company, maximization of overall company operations, development of financial policy and procedures, financing of corporate activities, maintenance of the accounting system, legal advice, public relations, purchase and sale of raw crude oil and raw materials, and coordination between the refining and other operating functions so as to obtain an optimum short range operating program." 447 U.S., at 207.
>
> In this case the parent company's operations are not interrelated with those of its subsidiaries so that one's "stable" operation is important to the other's "full utilization" of capacity. 447 U.S., at 218. See also id., at 225. The Woolworth parent did not provide "many essential corporate services" for the subsidiaries, and there was no "centralized purchasing office . . . whose obvious purpose was to increase overall corporate profits through bulk purchases and efficient allocation of supplies among retailers." Id., at 224.

Woolworth demonstrated that strong centralized management was not present. Woolworth was able to demonstrate that it did not exert an active centralized management over the four subsidiaries. Woolworth was therefore found not to be conducting a unitary business with its four subsidiaries.

In ASARCO, the United States Supreme Court found that ASARCO did have a potential to control the subsidiaries. However, the Court found that ASARCO had not asserted its control over the subsidiaries. Strong centralized management was not present.

In Container, the California Court of Appeals found taxpayer to be conducting a unitary business based in part on strong centralized management. Container Corporation was a Delaware corporation headquartered in Chicago and engaged in the production and distribution of paperboard packaging materials. Container Corporation was subject to corporate franchise taxes on its activities in California. Container Corporation argued that its California and out-of-state operations did not compromise a unitary enterprise to which the Franchise Tax Board could properly apply its formula for apportionment of income. The Court of appeals found that Container Corporation was indeed a unitary business and

allowed the Franchise Tax Board to apply its apportionment formula to Container Corporation's total income in order to establish tax liability. The Court stated that there was unity of ownership since the parent corporation owned the subsidiaries. Unity of operation was established based on the intercorporate loans. Finally, the Court found unity of use based on centralized management and technical assistance. Significantly, the Court went on to state that the flow of goods is only a factor and is not in and of itself determinative in finding a unitary business. The Court stated:

> Because a substantial flow of goods between the parent and its subsidiaries is not requisite to unitary status, the operational interrelationship of the corporate entities must be evaluated. The integration of major executive functions is a factor of great importance pointing toward unity. (See Chase Brass & Copper Co. v. Franchise Tax Bd., supra, 10 Cal.App.3d 496, 504, 95 Cal.Rptr. 805.) Although the everyday operations of the subsidiaries were handled by local employees, major policy decisions of the subsidiaries were subject to review by appellant. "The 'major policy matters' are what count in our estimation of integration." (Chase Brass & Copper Co. v. Franchise Bd., supra, 10 Cal.App.3d 496, 504, 95 Cal.Rptr. 805.) High officials of appellant gave directions to subsidiaries for compliance with the parent's standard of professionalism, profitability and ethical practices. Appellant constantly reviewed the financial reports of its subsidiaries; if these reports had not given sufficient information of a subsidiary's condition, appellant would have intervened. The submission of financial reports on a monthly basis from the subsidiary to the parent corporation is of some significance. (See Standard Register Co. v. Franchise Tax Board, supra, 259 Cal.App.2d 125, 136, 66 Cal.Rptr. 803.) Appellant's officials served on boards of directors of most of the subsidiaries. Thus, control on the highest level was exerted by appellant. Appellant also employed a "foreign operations staff" to oversee the subsidiaries, to prepare studies regarding the subsidiaries' activities and to give directions to the management of the subsidiaries.
>
> Appellant's policy of regional decentralization was followed by the subsidiaries. The parent corporation was involved with the training of local nationals for management positions. Appellant provided important personnel, equipment and financing to assist its first foreign subsidiary to enter the paperboard packaging industry. Such assistance in the initial stages of operation was crucial to the success of the subsidiary. Appellant continued to provide technical assistance to its subsidiaries. The subsidiaries had ready access to appellant's expertise. The subsidiaries were only charged costs and an apportionment of overhead; in some cases the charges were not recovered. The extent of the technical assistance provided by appellant was substantial; it included design work, sample packaging, marketing research, formula methods used in packaging and cost accounting. Appellant did not provide extensive technical service to any nonaffiliated corporations. The subsidiaries were prohibited from transferring information received from appellant to third parties. 173 Cal.Rptr. at 127-128.

Container was therefore found to be conducting a unitary business with its subsidiaries based on strong centralized management.

Finally, in <u>Chase Brass</u> the Court placed considerable significance on the centralized executive force of the parent to determine that the parent and its subsidiary corporations conducted a unitary business.

> The integration of executive forces is an element of exceeding importance. It is top level management which is credited (or, in the case of failure or indifferent results, debited) with the effects of corporate enterprises. Chief executives of large organizations are regarded as highly prized acquisitions. They are induced to join a corporation, or to remain with it, and to exert their best efforts, not only by generous salaries, but also in many cases by incentive plans of various kinds. For a subsidiary corporation to have the assistance and direction of high executive authority of such a corporation as Kennecott is an invaluable resource. The stipulation of facts reads: "The day to day operations of the subsidiaries were the concern of the executives of the subsidiaries and were handled by various subordinate employees of the subsidiaries. The Board of Directors of Kennecott was primarily interested in, and devoted the majority of its time to, the larger problems facing the copper industry in general, including the development and maintenance of its fabricating subsidiaries. The President of Kennecott was concerned with basic problems and policies of the subsidiaries. The executives of the subsidiaries reported to the President of Kennecott with respect to major policy matters." The "major policy matters" are what count in our estimation of integration. Day to day operations are made at various levels by many executives in any organization. They are made, no doubt, by a multitude of officials of Kennecott and its subsidiaries. Major policy is another thing. This was the main concern of Kennecott. 10 Cal.App.3d, at 504.

A group of companies which are engaged in separate operations but which are functionally integrated and where strong centralized management is exercised regarding its primary business functions are part of a unitary business. See, Dexter, <u>The Unitary Concept in State Taxation of Multistate-Multinational Businesses</u>, 10 Urb. Law. 181 (1978).

F. The 50 percent ownership test is set out in Minn. Stat. Section 290.17, subd. 2, clause (4), 2nd paragraph. Under the statute, the test to determine a unitary business is the "mutual benefit, dependent upon, or contributory to" test. In order to clarify this test, the rule does include a common ownership threshold before the test applies. This rule charifies that threshold.

The statute also provides that a unitary business will be presumed if the unity of ownership, operation and use are present. The unity of ownership is then defined. The statute needs to be clarified by this rule to provide for indirect ownership. Clearly the statute must be read to find the unity of ownership present when the corporate parent owns 100 percent of the stock of the first tier subsidiary, which in turn owns 100 percent of the stock of the second tier subsidiary.

The three unities test cannot be read to be more restrictive than the statutory test. The three unities test is merely a statutory example of a unitary business. The rule states that there must be two or more corporations involved in order to find a unitary business. In determining a common owner, the Department will look not only at direct ownership but also constructive ownership of voting stock to determine who has effective control of the corporation. The 50 percent ownership test focuses on who has effective control of the enterprise. The test is applied by the Department to pierce through mere form or appearances and ascertain who, in substance, has ownership and therefore control. The definition of common ownership is intended to circumvent any attempt at changing the nature of a taxpayer or taxpayer's form in order to avoid the application of the unitary tax treatment to a group of corporations where common ownership does exist. Therefore, the Department will look at the stock ownership by a corporate taxpayer, the stock ownership by partnerships and individuals, the relationship between the taxpayers and whether any constructive ownership exists so as to establish common ownership for purposes of implementing the unitary business concept and combined reporting. For this reason the Department will look at the total ownership structure. It should be noted that the indirect ownership test is the same as that used by the Internal Revenue Code to determine related parties.

Example 1. sets out the situation where common ownership is shown to exist between all four corporations through effective control based on ownership. Indirect and constructive ownership exist for the entire group. Corporation P directly owns 51 percent of the voting stock of Corporation R1 only. Corporation P does not directly own any of the stock of either Corporation R2 or R3. However, Corporation R1 directly owns 51 percent of the voting stock of both Corporations R2 and R3. Common ownership exists because R1 controls R2 and R3, and P controls R1.

Example 2. demonstrates that there must be over 50 percent ownership in order to establish sufficient ownership and implement the unitary business and combined reporting requirements. Common ownership exists between Coprporation P and Corporation R1. Common ownership also exists between Corporation R2 and Corporation R3. Common ownership does not exist between Corporation R1 and Corporation R2 since Corporation R1 owns only 49 percent of Corporation R2. Since R1 does not have control over R2, the rule states that there is no common ownership between Group A and Group B.

C. The first example sets out a unitary business which is vertically integrated. The four subsidiaries and parent in the example are all highly interrelated from the research and drilling for oil to the transport, refining and selling of the finished product. Flow of goods is established within the unitary group. Selling corporation owns 51 percent of the outstanding voting stock in each of the four subsidiaries. Common ownership is established. The parent corporation and four subsidiaries are conducting a unitary business.

In Exxon, which has previously been discussed, the Court found that there was in fact a flow of goods. Exxon was found to be a vertically integrated unitary business from its exploration, drilling, research and production functions to its refining, storage, transportation and sale to the ultimate consumer. The

benefits from this vertical integration to Exxon were substantial and have been previously discussed.

Example 2. demonstrates a unitary business which is horizontally integrated. Corporation A is in the primary business of operating multiline department stores. The other subsidiaries, B and C, operate retail department stores in other areas of the country. Subsidiary D provides the financing in order to facilitate the sale of the goods by the parent and two subsidiary corporations. Corporation E acts as the purchasing agent for Corporations A, B and C and maintains the warehouses for these corporations' inventories. Corporation A is providing the management and maintains the overall control in determining the primary business policies respecting the primary business activities of the other corporations. All five corporations are of mutual benefit, dependent upon and contributory to each other. Common ownership has been established. The corporations are engaged in a horizontally integrated business. The corporations are conducting a unitary business. See, generally, Edison California Stores; Western Auto; Butler Brothers; Associated Dry Goods; Valley Markets; Rothschild. The example sets out that centralized purchasing was done on behalf of the unitary group. See, Edison California Stores; Western Auto; Butler Brothers. Centralized management regarding the primary business activities of the unitary group is set out in the example. See, Woolworth; Edison California Stores; Western Auto; Associated Dry Goods; Valley Markets; Rothschild. All corporations in the example are engaged in the retail business or in supportive functions to the retail business. See, Edison California Stores; Western Auto; Butler Brothers; Associated Dry Goods; Valley Markets; Rothschild.

Example 3. demonstrates a unitary business which has strong centralized management. As noted in example 3., there is no significant flow of goods between any of the corporations. Furthermore, each of the individual corporations are

autonomous as to their daily operations. The example includes corporations which are engaged in the manufacturing and sale of canned goods, the operations of a chain of department stores, the manufacture and sale of household goods, and the development and marketing of computer software and programs. However, the subsidiaries do not operate as distinct and discrete business enterprises. See, Mobil. Corporation E is involved not only in the major policy determinations but in the approval of annual budgets, approval of capital expenditures, approval of financing arrangements, preparation of tax matters, performing of centralized warehousing and accounting functions for the subsidiaries. Corporation E and its subsidiaries form a diverse and multifaceted corporate conglomerate. The exercise of strong centralized management as enumerated in the example establishes a unitary business. See, Woolworth; ASARCO; Mobil; Container; Superior Oil Company v. Franchise Tax Board, 386 P.2d 33 (1963); Honolulu Oil Corporation v. Franchise Tax Board, 386 P.2d 40 (1963).

The presence of strong centralized management has already been discussed in Woolworth, ASARCO, Container, Exxon, and Chase Brass. As Woolworth points out, the central inquiry is whether there is centralized control of the primary business activities of the unitary group. If centralized control exists, then the corporations are conducting a unitary business.

Please note that the preparation of tax matters was specifically mentioned in Woolworth. The Department wishes to point out that it will not bootstrap a taxpayer into unitary by demanding a unitary combined return and then use the return as an element in proving that taxpayer is conducting a unitary business. The Department will therefore only look at the preparation of the federal return as an element in proving or disproving unitary.

Two additional cases which have not been discussed which show strong centralized management are Superior Oil and Honolulu Oil. Superior Oil was not a vertically integrated oil company, as it did not engage in refining and processing. It engaged only in producing and selling petroleum and petroleum products in California and seven other states. Typically, Superior Oil sold its crude petroleum at the well site to other companies. All of its California crude oil was sold within the state and all of its crude oil produced outside the state was sold outside of California. Its executive office was in Los Angeles, which handled accounting, insurance, and the purchasing of equipment for the entire enterprise. Personnel were moved frequently throughout the several states where Superior Oil operated. Superior sought unitary business treatment in order to apply losses incurred in Arkansas and Louisiana to offset its California income. California, on the other hand, wanted to tax Superior as a separate business. The court rejected the state's position and found that Superior was a unitary business. The court's decision was based on the centralized performance of certain supporting functions by Superior's executive office, and its contribution to out-of-state business. The court declared on page 39 that:

> It is only through a multitude of individual operations which precede and make possible the outflow of petroleum at a producing well that Superior is able to obtain possession of a product which it can market. While the actual recovery and sale of the crude oil are, perhaps, local activities, nevertheless very extensive interstate transactions are involved in the other individual operations which make such production possible. The evidence here reveals that such essential factors as land acquisition, exploration, technology, testing, availability of equipment and personnel, financing, and many others are definitely interstate in character. It must also be considered that each producing well in a particular state is the end product of interstate activities which may involve many other unproductive wells in many other states. Superior's products are thus acquired for the local market only as a result of interstate transactions . . . .

The factual situation in Honolulu Oil is substantially the same as in Superior Oil. The issue before the court was whether Honolulu Oil's business was unitary in nature entitling it to report its California income by the employment of an allocation formula. The court quoted Butler Brothers which held that the unitary nature of a business was definitely established by the presence of the

following factors: 1. unity of ownership, 2. unity of operation as evidenced by central purchasing, advertising, accounting and management division, and 3. unity of use in its centralized executive force and general system of operation. The court in Honolulu Oil felt that unity of ownership and unity of use were manifestly present in the case. Also, unity of operation which the California Franchise Tax Board apparently directed its contentions against appeared to be also satisfied. As stated, unity of operation is evidenced by central purchasing, advertising, accounting and management, all of which except for advertising appears as a matter of record to have been centrally controlled in the instant case. The court stated that exploration and development are not an end in and of themselves, but are only the forerunners of production and processing in Honolulu's scheme to create revenue. The court went on to find that where the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary. See, Edison Stores. Both Superior Oil and Honolulu Oil were found to be unitary based on strong centralized management.

13 MCAR Section 1.6502 - Intercompany Transfers Within the Unitary Business.

Statement of Need and Reasonableness

The authority for this rule is contained in Minn. Stat. Section 290.34, subd. 2. Minn. Stat. Section 290.34, subd. 2 states in relevant part that "All intercompany transactions between companies which are contained in a combined report shall be eliminated." The rule sets out that intercompany transactions which are eliminated include income, loss, expense or deduction items and items used to compute the apportionment factors.

The elimination of intercompany transactions within a unitary business is both reasonable and necessary for the following reasons:

1. Intercompany eliminations are necessary in order to eliminate double counting. An example is the taxation of the operating income of a subsidiary on the combined report and then the taxation of the dividend income received by the parent corporation. In ASARCO, the United States Supreme Court approved at page 3107 this elimination of the intercompany transaction. Double counting must be eliminated to prevent a distortion of the factors and income reportable to Minnesota.
2. By eliminating intercompany transactions, a unitary business is treated as one corporation conducting its business activities both within and without the State of Minnesota. This is in conformity with the basic concept behind unitary tax treatment and combined reporting of multicorporate and multinational corporations. The tax consequences for a multicorporate or multinational corporation should be the same as they are for one corporation where both conduct business both within and without the State of Minnesota. By eliminating intercompany transactions, this equality is achieved.

3. By eliminating intercompany transactions, a multicorporate enterprise cannot distort the amount of its activities, both within and without the State of Minnesota. The distortion becomes especially important when attempting to determine both the amount of taxable income of that entity to Minnesota and the factors used in apportioning income of the entity between Minnesota and the other states.

4. The elimination of intercompany transactions, as required by Minnesota, would be uniform with other states which impose combined reporting under the unitary business concept. Therefore, a company in determining its proportionate share of taxable income to Minnesota would be following the same rules as in other states. The Department has adopted this procedure which is similar to that used by Illinois. See, Illinois Regulation Section 304-1(F)(4), Illinois CCH State Tax Rptr., Vol. 1, p. 1327. It is therefore extremely important to remove intercompany transactions which would distort the amount of income reportable by the unitary group or which would distort the factors used to apportion the income among the members of the unitary group. This is consistent in allowing the unitary business to be treated as one entity. The purpose of eliminating intercompany transactions is to see the unitary business entity as one whole. Therefore, intercompany transactions cannot be allowed since it would allow a unitary business to generate artificial expenses and sales. These expenses and sales would prevent seeing the total unitary entity as one.

Finally, the Minnesota legislature has recognized the importance of eliminating intercompany transactions. Originally the law was changed by the Minnesota Legislature, 1981 Laws, Third Special Session, Chapter 2, Article 3, Section 14 to eliminate intercompany dividends only within a unitary business. The law was later changed by the Minnesota Legislature, 1982 Laws, Chapter 523, Article 20, Section 4 to state that all intercompany transactions between companies

which are contained on the combined report shall be eliminated. All intercompany transactions must therefore be eliminated. The only exception, as provided in the rule, is where a corporation can demonstrate an unusual situation and where it can demonstrate that, in fact, no distortion of income results. For purposes of reporting income or deduction items, if a taxpayer has filed a federal consolidated return and totaled the items, the Department could accept the combined return without the elimination of intercompany transactions. This exception is contingent on taxpayer having the same companies included on both its federal consolidated return and its combined report. It is also contingent on taxpayer showing the Department that no distortion would result by allowing taxpayer to file in this manner. The Department will allow taxpayer to file under this exception in order to ease taxpayer's burden in reporting to Minnesota. However, for purposes of determining the factors, in all cases, all intercompany transactions must be eliminated. This is necessary since the factors, especially the sales factor, can be easily inflated by intercompany transactions. Since the unitary business is seen as one unit, for purposes of the factors, all intercompany transactions must be eliminated to prevent distortions.

13 MCAR Section 1.6503 - Unitary Business, Reporting.

Statement of Need and Reasonableness

A. The first sentence in this paragraph allows a 100 percent Minnesota unitary business to file a combined report for each corporation. The authority for paragraph A. of this rule is contained in Minn. Stat. 290.17, subd. 2(4). Minn. Stat. 290.17, subd. 2(4) states in relevant part that "If the trade or business carried on wholly or partly in Minnesota is part of a unitary business, the entire income of that unitary business shall be subject to apportionment under Section 290.19." It is the Department's position that based on this authority, a 100 percent Minnesota corporation would be allowed to file a combined report. This provision is reasonable for the following reasons:

1. It is the Department's position that all corporations which are part of a unitary business shall be treated equally. Therefore, no distinction should be made between a unitary business which conducts its business both within and without Minnesota and a unitary business which conducts 100 percent of its business within Minnesota.
2. The provision is inserted so that a unitary business which is conducting 100 percent of its business within Minnesota is not penalized because of different reporting methods, for conducting all of its business within Minnesota.
3. The Department does not want to encourage a unitary business which is conducting 100 percent of its business in Minnesota to begin to transact business outside the state merely to qualify for combined reporting.

The second sentence states that should the Minnesota corporation elect to file a combined report that it must use the equally weighted arithmetic average of the factors. The authority for this provision is contained in Minn. Stat. Sections 290.17, subd. 2(3) and 290.19, subd. 3. Minn. Stat. Section 290.17, subd. 2(3) states that:

> Income derived from carrying on a trade or business, including in the case of a business owned by natural persons the income imputable to the owner for his services and the use of his property therein, shall be assigned to this state if the trade or business is conducted wholly within this state, and to other states if conducted wholly without this state.

Minn. Stat. Section 290.19, subd. 3 states that "Nothing in this section shall prevent the application of Sections 290.17 and 290.18 to that portion of a taxpayer's income which is not from a trade or business carried on partly within and partly without this state." The use of the equally weighted arithmetic average is reasonable as a familiar means of dividing up corporate income. To do otherwise would be doing a consolidated return which is not permitted under Minn. Stat. Section 290.34, subds. 2 and 3. This provision is necessary so that a distortion does not take place in allowing a Minnesota unitary business to elect either the arithmetic or weighted averages among the individual members of the unitary group. Under certain circumstances, a distortion of income can occur resulting in the underreporting of taxable income to Minnesota even though all the income was earned in Minnesota. This provision corrects this distortion by requiring all corporations within the unitary business which conducts 100 percent of its business within Minnesota to use the arithmetic average in reporting its income to Minnesota.

The third sentence in the paragraph entitles each member of the unitary group to have its first $25,000 of income taxed at the lower tax rate. The authority for this provision is contained in Minn. Stat. Section 290.06, subd. 1. The provision is reasonable since it treats all corporations equally, regardless of whether a corporation is part of a unitary business. No corporation is excluded from this provision based on its unitary or non-unitary status. The Department feels this provision is mandatory based on Minn. Stat. Section 290.06, subd. 1.

The last sentence in this paragraph states that banks and bank holding companies are subject to all the provisions contained in paragraph A. The authority for this provision is contained in Minn. Stat. Section 290.34, subd. 2 which specifically excludes insurance companies from combined reporting. All other companies which are not specifically excluded are thereby included for combined reporting. Minn. Stat. Section 290.17, subd. 2(4) is therefore applicable to banks and bank holding companies. This provision is reasonable in that it subjects banks and bank holding companies to the same requirements as all other companies which are part of a unitary business and are subject to Minn. Stat. Section 290.17, subd. 2. All companies are treated equally under combined reporting. It is the Department's position that banks and bank holding companies are subject to the provisions of a unitary business under Minn. Stat. Section 290.17, subd. 2(4) and that they are required to file using the combined income approach.

B. Every corporation that is part of a unitary business and has nexus with Minnesota is required to file a combined report. The authority for this statement is found in Minn. Stat. Section 290.17, subd. 2(4). This provision of the rule implements the Commissioner's authority to require combined reporting under Minn. Stat. Section 290.34, subd. 2. Minn. Stat. Section 290.17, subd. 2(4) states in relevant part that "If the trade or business carried on wholly or partly in Minnesota is part of a unitary business, the entire income of that unitary business shall be subject to apportionment under Section 290.19."

Minn. Stat. Section 290.17, subd. 2(4) states that "when a trade or business is carried on partly within and partly without this state, the entire income derived from such trade or business . . . shall be governed, except as otherwise provided in Sections 290.35 and 290.36 by the provisions of Section 290.19 notwithstanding any provisions of this section to the contrary." Minn. Stat.

Sections 290.35 and 290.36 provide that insurance companies and investment companies are to be taxed by Minnesota based on a single factor formula. Insurance companies are specifically exempted from the combined reporting requirements under Minn. Stat. Section 290.34, subd. 2. Since investment companies allocate income by use of a single factor and not the normal corporate three factor formula, it is reasonable to treat investment companies like insurance companies. These companies are therefore excluded from unitary tax treatment and the combined income approach. It is the Department's position that because of the unique character of these corporations the unitary tax treatment and combined reporting requirements would not accurately reflect these corporations' taxable income to Minnesota.

C. The first sentence in paragraph C. states that farm income is specifically excluded from combined reporting. The authority for this provision and paragraph is found in Minn. Stat. Section 290.17, subd. 2, clause (4), first paragraph, and the law change made by the Minnesota Legislature in Laws 1981, Third Special Session, Chapter 2, Article 3, Section 13. Minn. Stat. Section 290.17, subd. 2(2) states that "the income from the operation of a farm shall be assigned to this state if the farm is located within this state and to other states only if the farm is not located in this state." Minn. Stat. Section 290.17, subd. 2(4) goes on to state that the specific clause is not applicable to income from the operation of a farm.

The second sentence sets out that to the extent a farm is part of a unitary business, that unitary business must exclude the farm income when figuring its combined income or loss under the combined income approach. In a situation where the Minnesota farm as part of a unitary business makes sales to another member of the unitary business outside the state, that sale must be treated as if made at fair market value. This is necessary so that transactions between the unitary business and the farm business stay separate and distinct for

purposes of reporting income and loss to Minnesota. Farm income is to be reported on a separate accounting basis. Minnesota law specifically sets out that the unitary tax treatment is not applicable to farming. In order to assure full accountability, the income and operations of the farm must remain separate from the unitary business. Therefore, any sales between the farm and the unitary business where the farm is part of that unitary business must be treated as being made at fair market value to prevent any distortions of income and to insure full accountability of the farm income to Minnesota. The last sentence in paragraph C. allows expenses connected with a farm to be taken under separate accounting. This provision is consistent with the provision of Minn. Stat. Section 290.17, subd. 2(2) and the other provisions in this paragraph since it allows a corporation to report income and expense items using a uniform method which adequately reflects taxpayer's farming operations.

D. This paragraph allows each corporation having nexus with Minnesota and which is part of a unitary business to subtract its charitable deduction from its apportioned unitary income. The authority for this paragraph is contained in Minn. Stat. Section 290.21, subd. 3 which allows corporations a deduction for charitable contributions. Each separate corporation will be allowed to subtract from that corporation's apportioned income based on the combined income approach its charitable deduction. In order to utilize the charitable contribution deduction, the corporation itself must have nexus with the State of Minnesota. It is not sufficient that nexus is established for the corporation based on the unitary concept. Sufficient contact must be present for each separate corporation with the State of Minnesota in order for the corporation to use the charitable contribution deduction. The corporation's charitable contribution deduction is computed in the following manner: all charitable contributions made by the separate entity are allowable as deductions on that corporation's Minnesota income tax return. Furthermore, the rules provide that a percentage of the charitable contributions made by the unitary group after deducting

contributions made by the separate corporation are also allowable based on the ratio of taxable net income of the individual corporation to the total net income of the unitary group. The authority for this allocation is contained in Minn. Stat. Section 290.21, subd. 3(d). Therefore, each separate corporation which has nexus with Minnesota would be allowed to deduct in full its contributions made within Minnesota. In addition, for corporations which are part of a unitary group, a charitable contribution deduction is allowed based on the ratio of Minnesota's taxable net income of that particular corporation to the total net income of the entire unitary group. This ratio computation is used only after all contributions made by the separate corporate entity to Minnesota are first deducted. In this way, the law maximizes the advantage to any corporation which desires to make charitable contributions within the State of Minnesota. This provision is reasonable for the following reasons:

1. The provision allows each separate corporation having nexus with Minnesota to deduct its Minnesota charitable contributions in full. In certain situations, a corporation having nexus with Minnesota which is part of a unitary business might not be allowed to take its full deduction for charitable contributions made within Minnesota. This provision prevents a corporation having nexus with Minnesota which is part of a unitary business from being penalized.
2. The provision treats equitably both separate corporate taxpayers and corporations which are part of a unitary business.

E. This paragraph sets out Minnesota's treatment of credits. Basically, the rule states that any refundable or nonrefundable credits which are allowed under Minnesota law must be taken by the corporation based on that individual corporation's expenditures within the state. The separate corporation claiming the credits must have established a nexus with the state for the taxable year based on its own activities within the state. It is not sufficient that nexus has been established for the unitary group of which the separate corporation is a

member. The separate corporation must in and of itself have sufficient contacts with the State of Minnesota in order to establish nexus for purposes of claiming any credits on the Minnesota tax return. The nonrefundable credits are granted as a matter of legislative grace to corporations based on that corporation's activities within the state. These nonrefundable credits are designed to encourage expenditures by corporations in specified areas in Minnesota. Minnesota credits include Minnesota Statute Sections:

290.06, subd. 9 - Pollution Control Credit

290.06, subd. 9a - Feedlot Pollution Control Credit

290.06, subd. 14(c) - Energy Credit

290.068 - Research Credit

290.06, subd. 13 - Gas Tax Credit

290.936 - Estimated Tax Credit

The first four credits are nonrefundable while the last two credits are refundable.

These laws provide that these credits belong only to a corporation that makes payments or incurs expenses. There is no authority for a consolidated return in which all expenses or payments would be consolidated. The combined report is only a method of reporting income. Credit amounts aren't combined. Minn. Stat. Section 290.34, subd. 2 provides only for combining income. That also is the only effect of Minn. Stat. Section 290.17, subd. 2(4). The rule is reasonable for the following reasons:

1. Credits taken by a corporation which is a member of a unitary business are based only on that corporation's expenditures which create the credits. This treatment is uniform with the treatment afforded corporations which have nexus with Minnesota and which are not a part of a unitary business.
2. Where a corporation having nexus with Minnesota is part of a unitary business, it is allowed to take its Minnesota credit against its proportionate income from the entire unitary business.

F. This paragraph sets out Minnesota's position regarding the computation of a corporation's minimum tax under Minn. Stat. Section 290.091. For purposes of determining a corporation's minimum tax to Minnesota where the corporation is a member of a unitary group, said corporation must determine its tax liability by using 40 percent of the federal minimum tax liability as computed on its federal return. The separate computation of the minimum tax is consistent with the computations of the credits. However, where a consolidated federal return was filed, the minimum tax must be based on the consolidated return where the same corporations are on the federal consolidated return as appear on the combined report. The reason for this special treatment is that this is the method used for federal purposes and it is consistent with the method of reporting to Minnesota. This is seen as a convenience to the taxpayer. The minimum tax liability for said corporation is then multiplied by the statutory ratio, the numerator of which is the taxpayer's preference item income allocated to Minnesota and the denominator of which is the taxpayer's total preference items for federal purposes. The authority for this provision is contained in Minn. Stat. Section 290.091 which imposes a Minnesota minimum tax of forty percent (40%) of a taxpayer's federal minimum tax with certain modifications. A separate corporation which is part of a unitary group and which has a nexus with Minnesota computes its minimum tax based on its proportionate tax preference income to the tax preference income of the entire unitary group.

G. Paragraph G. relates to the acquisition by a unitary business of another corporation. The paragraph sets out when the newly acquired corporation must be included in the unitary business's combined report. The inclusion of the newly acquired corporation in the unitary business is necessary in order for the unitary business to accurately reflect both its taxable income and business operations to Minnesota. The authority for this provision is contained in Minn. Stat. Section 290.17, subd. 2(4). Minn. Stat. Section 290.17, subd. 2(4) states in relevant part that "If the trade or business carried on wholly or

partly in Minnesota is part of a unitary business, the entire income of that unitary business shall be subject to apportionment . . . ." Taxpayer is allowed to exclude a new corporation in its combined report until the first taxable year of the acquiring corporation which begins after the date of acquisition. This provision is proposed in order to allow sufficient time to make the necessary adjustments to assimilate the newly acquired corporation into the unitary business and in order to allow for the necessary changeover of internal procedures, both functional and staff, within the unitary business group. As has been stated earlier in the rule, mere ownership alone is not sufficient to demonstrate a unitary business. Additional factors must be found to establish that a unitary business does exist between the original unitary business and the newly acquired corporation. Whether the factors demonstrate vertical integration, horizontal integration, or strong centralized management, such additional factors must be found to establish that a unitary business exists. It would, therefore, not be possible to classify a newly acquired corporation as part of a unitary business until sufficient time has elapsed in order to demonstrate that such additional factors do indeed exist. It is the Department's position, therefore, that taxpayer should not be required to immediately include the newly acquired corporation on the combined return of the unitary business. However, this exception does not apply to a corporation created from a part of the previous unitary business. The reason is that this business was part of the unitary group originally. Therefore, the unitary attributes are already established.

H. The unitary business concept and combined income approach is applicable to banks and bank holding companies. The statutory authority for their inclusion within the unitary business concept is contained in Minn. Stat. Section 290.17, subd. 2(4). Minn. Stat. Section 290.17, subd. 2(4) states in relevant part that "when a trade or business is carried on partly within and partly without the state, the entire income derived from such trade or business . . . shall be governed,

except as otherwise provided in Sections 290.35 and 290.36 by the provisions of Section 290.19 notwithstanding any provisions of this section to the contrary." Minn. Stat. Sections 290.35 and 290.36 set out how insurance companies and investment companies are to be taxed by the state. These companies are excluded from unitary tax treatment and the combined income approach. The statute does not specifically exclude banks and bank holding companies from the application of the unitary business and combined reporting. It is the Department's position that there is nothing inherently different in the business of banking than is found in other businesses which are subject to the unitary business concept and combined reporting. Absent specific statutory authority granting banks and bank holding companies an exception from unitary tax treatment, banks and bank holding companies are subject to Minn. Stat. Sections 290.17, subd. 2(4) and 290.34, subd. 2.

The inclusion of banks and bank holding companies within the unitary tax treatment is reasonable for the following reasons:

1. The inclusion of banks and bank holding companies is mandated by Minn. Stat. Section 290.17, subd. 2(4).
2. There is nothing inherently different between the business of banking and other businesses subject to combined reporting.
3. The application of combined reporting to banks and bank holding companies helps prevent distortions in reporting income to Minnesota and
4. Finally, unitary tax treatment encourages full accountability of a bank's activities within all the states.

Receipts from intangible personal property are included in the sales factor of banks for purposes of determining the apportionment factor and the banks' unitary business conducted within Minnesota. Normally, receipts from intangible personal property would not be included in a unitary business's sales factor in order to determine the amount of taxable income to Minnesota. However, banks

are in the general business of making loans and therefore intangible personal property becomes the key asset for these institutions. It is the Department's position therefore that intangible personal property must be used as a component of the sales factor to properly determine apportionable income. Minn. Stat. Section 290.19, subd. 1(2)(a)(1) states that the sales factor is determined by "The percentage which the sales, gross earnings, or receipts from business operations, in whole or in part, within this state bear to the total sales, gross earnings, or receipts from business operations wherever conducted." The rule therefore provides how a bank computes its sales factor under this provision since banks have few if any merchandise sales. This position is consistent with California, which taxes banks in like manner. See, Guideline for Apportionment of Income of Banks and Financial Corporations, California CCH State Tax Rptr., Vol. 1, p. 1309 and 1310.

1. Interest and other receipts from assets in the nature of loans and installment obligations are attributed to the state where the office is located at which the customer applied for the loan. The only exception to this is where the loan is recognized by appropriate banking regulatory authority as being made from and is an asset of an office located in another state, in which case it is attributed to that state. It is the Department's position that by attributing the income to the state where the office is located and the loan originated, or was at least applied for, that this is the most efficient and effective manner in allocating said income among the different states. It is also the most acceptable and efficient approach as concerns the taxpayer and his methodology to determine and apportion said income. Basically, this means that the "sale" was made from that office and so should be allocated to that state. The second sentence in this paragraph defines the word "applied" to mean initial inquiry, including customer assistance in preparing the loan application or submission of a completed loan application, whichever occurs first in time. The initial point of

contact is treated as determinative for purposes of determining accountability of income and loss resulting from business transacted within the state. Again, this order of priority is established in order to make the computation of apportionable income as easy and efficient as possible for both the taxpayer and Minnesota. This approach is in conformity with the approach taken in California. See, Guideline for Apportionment of Income of Banks and Financial Corporations, California CCH State Tax Rptr., Vol. 1, p. 1308.

2. In addition, interest and service charges on credit cards including holders' fees must all be attributed to the state in which the credit card holder resides in the case of an individual. In the case of a corporation, said income must be attributed to the state of the corporation card holder's commercial domicile.

This treatment is reasonable since:

1. Taxpayer knows the address of the card holder and can most easily allocate the receipts on this basis.
2. Allocating based on taxpayer's office would make no sense. Allocating based on taxpayer's office would not only be difficult to determine but would be extremely difficult to substantiate and verify.
3. The approach adopted in the rule is the most reasonable since the state of residence or commercial domicile is the source of the loan since the customer is drawing on the loan.

If the taxpayer is found not to be taxable in the state of the individual card holder's residence or commercial domicile of the corporation card holder, the receipts are then attributed to the state of the taxpayer's commercial domicile. This approach to interest, service charges and credit card holder fees is in conformity with California's treatment. See, Guideline for Apportionment of Income of Banks and Financial Corporations, California CCH State Tax Rptr., Vol. 1, p. 1308.

The rule is reasonable because:

1. Minn. Stat. Section 290.19, subd. la states in relevant part that

   For purposes of this section the following rules shall apply in determining whether or not sales are made within this state.

   Sales of tangible personal property are made within this state if the property is delivered or shipped to a purchaser within this state, and the taxpayer is taxable in this state, regardless of the F.O.B. point or other conditions of the sale.

   Minn. Stat. Section 290.19, subd. la only applies to tangible personal property. It does not apply to intangible personal property.

2. The rule provides for a complete accounting of all receipts in the sales factor. A distortion in the sales factor would result if this provision was not incorporated into the rule.

3. Finally, if a taxpayer has a mere isolated contact with a state, there is no reason why the receipts from the transactions should not go back to the main office.

It is the Department's position that this approach is the most effective and efficient manner in which to tax this income. This approach simplifies the determination of where the income is attributable to and therefore taxable by any given state. This is seen as the best possible approach. It should be pointed out that Minnesota's approach conforms with California. See, generally, Guideline for Apportionment of Income of Banks and Financial Corporations, California CCH State Tax Rptr., Vol. 1, p. 1307-1310. It is the Department's position that conformity is both desirable and advisable in order to create uniformity among the states in taxing unitary businesses.

3. Merchant discount income is attributed to the state in which the merchant is located. This is contingent on the fact that taxpayer is taxable in that state. If the taxpayer is not taxable in the state, the merchant discount income is then attributed to the state in which the taxpayer's

commercial domicile is located. This provision is justifiable for the reasons provided in the preceding paragraph.

4. Generally, receipts from investments of a bank in securities are attributable to the bank's commercial domicile. There are two exceptions: (1) receipts from securities used to maintain reserves against deposits to meet federal and state reserve deposit requirements must be attributed to each state based upon the ratio the total deposits in the state bear to the total deposits everywhere, and (2) receipts from securities owned by a bank but held by a state treasurer or other public official or pledged to secure public or trust funds deposited in such bank must be attributed to the banking office at which such secured deposit is maintained. The approach outlined in the rule is the same taken by California in administering its tax laws allocating the receipts from a bank's investments in securities. Minnesota's approach as outlined in the rule attempts to adopt a uniform approach in this area consistent with other states. This approach is highly desirable in order to minimize differences between the states in administering their tax laws affecting a unitary business which is engaged in banking and bank related matters. Securities are intangibles. Intangibles have no geographic situs. Income from intangibles, which is part of a unitary business, is subject to three factor apportionment. It is generally said that the situs of intangibles is the bank's commercial domicile. See, Graves v. Schmidlapp, 315 U.S. 657 (1942); Hillstrom v. Commissioner of Revenue, 270 N.W.2d 265 (1978). In this situation, it would be unreasonable to say that the situs of the intangibles is in an office. Under this rule, the sales factor would follow the location of the intangibles. The rule provides for two exceptions. The two exceptions are allowed when the securities are identified and pledged and so have a geographical situs. The securities under the two exceptions are therefore allowed to be assigned to an office.

5. Receipts from the issuance of traveler's checks and money orders must be attributed to the state where the taxpayer's office is located that issued the traveler's checks or money orders. This general rule is consistent with the Department's approach to taxing the income and receipts of a unitary business engaged in banking. The Department therefore attributes said income to the location where the business was transacted. This is where the "sale" occurred. The taxpayer's records would reflect this. It really shows what specific business activities occurred in the particular state for sales factor purposes. In this case, that would be where the traveler's checks or money orders were issued. The remainder of the paragraph deals with situations where the traveler's checks or money orders are issued by an independent representative or agent. The receipts are attributable to the state in which the independent representative or agent issues the traveler's checks or money orders if the taxpayer is taxable in that state. Where the taxpayer is not taxable in the state, the receipts must be attributable to the state of commercial domicile of the taxpayer. This approach is consistent with the treatment of interest, service charges and credit card holder fees. This method is the most efficient approach in dealing with income generated by such transactions. Again, this method is consistent with that adopted by California in its treatment of unitary businesses which are conducting banking operations. See, Guideline for Apportionment of Income of Banks and Financial Corporations, California CCH Tax Rptr., Vol. 1, p. 1310.
6. This provision attributes receipts from investments of a financial corporation to its commercial domicile unless the securities have acquired a business situs elsewhere. This provision is very similar to paragraph 4 and is in keeping with the uniform treatment of a bank which is conducting a unitary business. This approach is also consistent with California.

I. Paragraph I. sets out Minnesota's reporting requirements regarding members of unitary group who have the same or different accounting periods. Members of a unitary business are treated as one entity and so the same common period must be used. The unitary business must therefore report to Minnesota using one common period of twelve (12) months. A common reporting period among the unitary members is necessary in order to correctly determine the income, factors and unitary attributes of the group. The second sentence of paragraph I. allows the unitary members to report to Minnesota using the parent corporation's accounting period. This treatment is identical to Illinois which also allows unitary members to report based on the parent corporation's accounting period. See, Illinois Regulation Section 304-1(B)(3), Illinois CCH State Tax Rptr., Vol. 1, p. 1327. California also uses this procedure as set out in their corporate tax instructions. See, California Franchise Tax Board, Instructions For Corporations Filing A Combined Report (1981) which states at page (8) that "In filing a combined report, it is necessary that the income of all corporations be determined on the basis of the same accounting period. Where there is a parent subsidiary relationship, the income of all corporations should be determined generally on the basis of the parent's income year." The Department relies on Minn. Stat. Section 290.07, subd. 1 as its authority to require members of a unitary group to reconcile their accounting periods to the accounting period of a member of the unitary group conducting business in Minnesota. The rule goes on to provide that where no parent corporation exists, the unitary members may select one corporation to be the parent corporation for purposes of a common accounting period. This provision was requested by an outside party. The justification for the provision is that it allows accountants to reconcile all the records of a unitary group to one corporation where no parent corporation exists. This allows the accountant to make just one visit to the client in order to do the tax returns.

The rule goes on to state that once a method is selected, it may not be changed without the permission of the Commissioner of Revenue. The authority for this provision is contained in Minn. Stat. Section 290.07. subd. 2 which requires a taxpayer to stay consistent for fair and proper income reporting.

The fifth and sixth sentences in paragraph I. set out how the income and factors for corporations should be treated for the first taxable year beginning after June 30, 1981. The rule sets out that no double counting of income or factors is allowed. The rule prevents overlap of income and factors during the transition period from filing on other than a combined return to now, as a unitary business, filing a combined return. The provision helps assure fairness, no distortions, and full accountability in reporting income to Minnesota. The authority for this provision is contained in Minn. Stat. Section 290.07, subd. 3(1)(b).

The seventh sentence in paragraph I. states that the due date of the corporate return is still based on the actual accounting period of the corporation. The authority for this provision is contained in Minn. Stat. Sections 290.07, subd. 1 and 290.42 (1) and (2). Minn. Stat. Section 290.07, subd. 1 requires taxpayer to employ the same accounting period as for federal. Minn. Stat. Section 290.42, (1) and (2) imposes basically the same rules for filing as is required for filing taxpayer's federal returns.

J. This provision was inserted into the rules in order to avoid penalizing corporations as a result of the transition period from reporting their income on other than a combined report to reporting their income as a unitary business under the combined income approach. Initially what would happen to numerous corporations if this provision had not been inserted was that net operating losses which they incurred prior to the law change would have been drastically reduced in carryforward years because of Minn. Stat. Section 290.095, subd. 3(c). Minn.

Stat. 290.095, subd. 3(c) allows the loss based on the apportionment ratio of the loss year or the year to which the loss was carried, whichever is smaller. Numerous corporations would have had a much smaller apportionment ratio to Minnesota as a unitary business under the combined income approach than they would have had in prior years where they were using a reporting approach different from the combined income approach. It is the Department's position that this was neither intended to occur based on the legislation that was passed, nor is it equitable to penalize corporations based solely on a change in Minnesota's tax law. This provision is therefore inserted so that said corporations are equitably treated regarding the carryforwards of their net operating losses into unitary tax years. It must be noted, however, that the rule would apply the statutory provision as it relates to the corporation's apportionment on a separate return basis. Therefore, if the corporation's apportionment ratio in the carryover year was smaller than in the loss year after computing it on a separate accounting basis, the statutory provision would apply. The result is that if the corporation (on a separate accounting basis) is leaving Minnesota, it must bear the statutory consequences of its action. The rule merely prevents the corporation from being unduly penalized based on a law change requiring the corporation to switch from a separate accounting basis to combined reporting.

The last sentence of paragraph J. restricts this provision to the situation where the corporation was part of a unitary group on the effective date of the combined reporting law. Only in these situations could it truly be said that the only thing that changed was the passage of the new law.

K. The rule sets out in paragraph K. that where any members of the unitary business employ different methods of apportioning their income to Minnesota, all members

must use the method used by the predominant business activity conducted. It was requested that this provision be inserted in the rule to clarify what happens when a combination is required between a corporation reporting on three factor and a corporation reporting using a single factor, separate accounting or some other method. The rule states that the method used by the predominant business activity must be used by all the members of the unitary group.

Minnesota Income Tax Rule 2019 - Apportionment of Net Income of Business Conducted Partly Within Minnesota.

Statement of Need and Reasonableness

Minnesota Income Tax Rule 2019 is amended in order to help clarify the rule as it applies to a business conducted both within and without Minnesota. The most important change is the change in the property factor.

The first change occurs in paragraph (a) which strikes out "an integral" and replaces it with "a part of a unitary business." The reason for this change is for clarification purposes. The Department is attempting to eliminate any confusion in this area as it relates to a unitary business. The Department wishes to stress that the trade or business must be a unitary trade or business conducted both within and without Minnesota in order for the formula to apply. By replacing the word "integral" with "unitary," the Department is attempting to eliminate any confusion as to just what is intended.

The next change occurs in paragraph (b) and is the deletion of "in Minnesota or within and without Minnesota." The deleted words were removed from the law in Laws 1969, Chapter 978 and they should also be removed from the rule.

The next change in the rule is in paragraph (b) and is a technical correction in the example. It merely corrects an oversight in the original rule relating to the calculation. The next change in paragraph (b) is made in order to eliminate any confusion regarding the example. The word "lesser" is eliminated and replaced with the word "weighted" in order to make the example more clear. The Department is attempting to eliminate any confusion that the previous language may have caused. No change in the meaning of the example is either intended or accomplished by the word change.

The first change in paragraph (c) is a deletion of the words "within or within and without Minnesota." The words are deleted based on the change made in Laws 1969, Chapter 978. The second change is the insertion of certain punctuation in order to make the rule grammatically correct. No change in the meaning of the rule is either intended or accomplished by these changes. The third change inserts "Minnesota" before property, payroll or sales percentage. This is for clarification. There is no change in the meaning of the rule. The fourth change replaces "integral" with "unitary." This change was explained under paragraph (a). The next change in the paragraph relates to the use of Schedules T and U. Since new forms have been developed for apportioning income and these schedules are no longer used, the sentence is obsolete and has no effect. It has therefore been deleted from this paragraph.

The change in paragraph (d)(1) eliminates the requirement in the old rule that in order for a business to consist of the manufacture of personal property in Minnesota that the operations of "manufacture" must occur within the geographical territory of Minnesota. The deleted words add nothing in describing the manufacture of personal property. The law was amended by the Legislature in Laws 1969, Chapter 978, which deleted provisions from subd. 1(1) limiting manufacture to "in Minnesota or within and without Minnesota." The deletion of this provision from the rule is necessary in order to correspond with the 1969 law change.

The first change in paragraph (d)(2) deals with the property factor and clarifies which property used by the taxpayer can be considered. Minn. Stat. Section 290.19, subd. 1(1)(b) and (2)(a)(2) requires that the property be used in connection with the taxpayer's trade or business. This change was made in Laws 1939, Chapter 146, Section 22. The law does not specifically require that the property, which is used by the taxpayer in the taxpayer's business, produce income. For this reason, the requirement is being dropped. The next change in paragaraph (d)(2) relates to

valuing tangible property which is owned by the taxpayer. The rule proposes to use the property's original cost and not its adjusted basis. There are several reasons for this change. The most important reason is that the change brings Minnesota's property factor calculation in conformity with other states which value property based on original cost. Section 11 of the Uniform Division of Income For Tax Purposes Act (UDITPA), as drafted by the National Conference of Commissioners on Uniform State Laws in 1957, provides for the valuation of property at original cost. It is the Department's desire to eliminate as many inconsistencies between the different states as possible in determining the property factor for a unitary business. The change is also necessitated by the fact that Minnesota has not adopted the full Federal Accelerated Cost Recovery System (ACRS) depreciation. Therefore, the calculations that will have to be made by both the taxpayer and the Department in order to determine the correct property factors would be extremely burdensome if the current adjusted basis system was used. This change is in the taxpayer's best interest since it allows a far easier calculation of the property factor. It also takes Minnesota a step closer to being uniform with the other states. It must be remembered that the law does not now nor has it ever required that the property factor be computed based on either adjusted basis or original cost. This has always been a subject the Department has dealt with by rule. The rule has provided for the use of adjusted basis since 1939 (see, 1939 Income Tax Rule Article 25-1). However, the Department feels a change should be made now to conform with the uniform law, methods of other states, and since the law requires a modification to ACRS depreciation.

The paragraph also incorporates the change in valuation based on any subsequent capital additions or improvements and partial dispositions by reason of sale, exchange or abandonment. This provision is seen as beneficial in accurately reflecting the true cost to the taxpayer not only at the time of original purchase but subsequently, where substantial changes are made to the property or where partial

dispositions are made of the same property. The provision is identical with the adjustments allowed in Regulation IV.11.(a) of the Multistate Tax Compact. The next change relates to the valuation of property which is rented by the taxpayer. The change would value rented property at eight times the annual rental rate, instead of the previous seven and one-half times. The rule had never provided for the method. It is current administrative practice to use seven and one-half times. Again, the Department is trying to conform with other states in determining the property factor. Specifically, this change and other changes concerning the rental calculation are copied from Section 11 of UDITPA. This change is in the taxpayer's best interest since it allows a more uniform calculation and avoids a difference among the states in determining the property factor. The definition of the net annual rental rate is also taken from UDITPA. The result of the provision is that only the rental expense that the taxpayer incurs can be considered. Expenses, which are paid by another as a sub-rental, are not considered. The next change states that rents during the year must not be averaged. The purpose of this provision is to disallow distortions in the factor based on the use of averages in the rents. This provision codifies current administrative practice (see, instructions for Form M-5). The rule provides an effective date for the property factor changes to eliminate any retroactive effect. The last provision states that all members of the unitary group must use this method in calculating their property factors. Again, the Department is inserting this provision to make sure that there are no distortions in reporting. The provision prevents members of the same unitary group from using different reporting methods in determining their property factor and their taxable income to Minnesota. It is the Department's position that this uniformity and equitable treatment of all members of the unitary group is the proper method for determining a corporation's true proportionate share of business done in Minnesota.

The entire paragraph (d)(4) has been eliminated since it in no way clarifies or adds to the rule relating to the sales factor. The authority for the deletion is

based on Laws 1973, Chapter 650, Article VII, Section 2, in which Minn. Stat. Section 290.19, subd. 1(4) was deleted in full. The deletion of this provision from the rule is necessary, therefore, in order to correspond with this 1973 law change.

The provision of paragraph (e) which references the allocation of federal income taxes paid, Rule 2018(1), has been deleted since it adds nothing to the rule.

13 MCAR Section 1.6004 - Minnesota Gross Income For Individuals Who Are Part Year Residents or Nonresidents of Minnesota (Federal Adjusted Gross Income).

Statement of Need and Reasonableness

The first change in this rule occurs in paragraph A.3.d.(2) and states that business conducted within Minnesota and which has nexus within Minnesota so that the business is subject to Minnesota income tax includes income or losses from sales whose destination is within Minnesota. The destination wording is considered necessary in light of the Minnesota Supreme Court decision relating to destination sales. See, Olympia Brewing Company v. Commissioner of Revenue, 326 N.W.2d 642 (1982). In Olympia, the Minnesota Supreme Court held that beer picked up at taxpayer's Minnesota brewery by out-of-state distributor-purchasers in their own trucks for transportation and resale outside Minnesota did not constitute a sale within the state for income tax apportionment. The insertion of the words "whose destination is" in the rule is therefore necessary to clarify which sales are includable within the rule.

The deletion in the same paragraph relates to construction businesses which had been required to report on the separate accounting basis. It is the Department's position that construction businesses should be subject to the normal three factor apportionment of income including the unitary tax treatment and combined reporting. Therefore, this provision is being stricken and eliminated from the rule. The authority for the inclusion of a construction business within those businesses subject to three factor apportionment and the unitary tax treatment and combined reporting is Minn. Stat. Section 290.17, subd. 2(4). Three factor apportionment is applicable to all corporations unless it can be shown that it does not properly reflect income. See, Minn. Stat. Section 290.19, subd. 1(2)(b). In light of the new unitary tax law, the Department feels that construction companies should be

treated like any other business and use the normal three factor formula. The additional provision stricken and the additional language inserted specifically excludes farm income and income from personal or professional services from three factor apportionment as business income. The authority for this deletion and insertion of additional language is Laws 1981, Third Special Session, Chapter 2, Article 3, Section 13 which amended Minn. Stat. Section 290.17, subd. 2(4) to specifically exempt farm income from three factor apportionment. Personal service income had previously been exempted. The changes in the rule are therefore necessary in order to comply with applicable law.

Minnesota Income Tax Rule 2017(3) - Assignment of Income to Minnesota - Income From A Trade or Business Conducted Wholly Within or Wholly Without the State.

Statement of Need and Reasonableness

As mentioned earlier, it is the Department's position that construction businesses should no longer be required to report on a separate accounting basis. Construction businesses are considered a unitary business for purposes of reporting their income to Minnesota and are required to file on a combined income approach. Therefore, Minnesota Income Tax Rule 2017(3) is no longer applicable and should be repealed. The authority for the repeal of Minnesota Income Tax Rule 2017(3) is Minn. Stat. Section 290.17, subd. 2(4). Unitary tax treatment is applicable to all businesses unless specifically excluded by law. Minnesota law provides no exclusion for construction businesses. It is therefore subject to Minn. Stat. Section 290.17, subd. 2(4) and Minn. Stat. Section 290.19. Minnesota Income Tax Rule 2017(3) must therefore be repealed in order to comply with current law.

Paragraphs 1 and 2 are unnecessary since they add nothing to Minn. Stat. Section 290.17, subd. 2(3).

Paragraphs 3, 4, and 6 are obsolete in light of the law changes made in Laws 1973, Chapter 650, Article VII when the law was changed from an office basis to a destination basis.

Paragraph 5 is obsolete in light of Laws 1969, Chapter 978.

Paragraph 7 is not needed since it adds nothing to Minn. Stat. Section 290.05, subd. 1.