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Business Strategists & Certified Public Accountants

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Flow of Value - Functional Integration: The Relationship Test of a Unitary Business Group

GRAND RAPIDS, MI – Monday, April 7, 2008 – The past two weeks, this newsletter discussed the "control test" and "attribution" for a "unitary business group." However, in addition to satisfying the control test, a unitary business group must have business activities or operations that (1) result in a *flow of value* between or among persons in the group, or (2) are *integrated with, are dependent upon, or contribute to each other*. [Treasury FAQ U8] The second test, relationship, has two parts, one of which must be satisfied. The first of these two parts is *Flow of Value*. Treasury, in FAQ U8 stated: "*Flow of Value*" is established when members of the group demonstrate one or more of functional integration, centralized management, and economies of scale. Today we will discuss "functional integration" and in the next two newsletters we will discuss the other two aspects of *Flow of Value*.

Functional Integration

Examples of functional integration include common programs or systems and shared information or property. The taxpayer must develop all the facts pertaining to "functional integration" and document their applicability to the unitary determination. This should be done whether the taxpayer wants to assert "functional integration" for purposes of inclusion into a "unitary business group," or exclusion.

Examples of staff functions that are considered in determining the presence of "functional integration" include functions such as:

- Central purchasing
- Manufacture and intercompany sale of products by one corporation to another member of the group for use such as supplies, raw materials, component parts, packaging or production equipment
- Sharing of technology or information relating to products produced by the group
- Joint distribution or storage of products
- Transfers of equipment used in the business
- Common advertising
- Centralized accounting, legal, or personnel functions
- Common insurance policies, pension plans or employee benefits
- Intercompany financing, when such financing serves more than a mere investment function

This list is, by no means, all-inclusive. Furthermore, the taxpayer must realize that the mere listing of central operating departments will carry little value if the taxpayer can successfully demonstrate that the connections are of little importance. The taxpayer must describe and document the extent of the

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centralization, and document the benefits derived by the corporate group from the "functional integration."

Common purchasing might be a very significant unitary factor if the key raw material used by each member of the group is centrally purchased at a substantial volume discount. On the other hand, if the products that are centrally purchased consist only of miscellaneous supplies, the centralization of the purchasing function will carry much less importance.

By the same token, centralized accounting may be significant if a single accounting office performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each subsidiary in the group. Often however, the term "centralized accounting" is used to describe a situation where a parent corporation compiles the data to prepare the consolidated Form 1120 tax return and retains the services of an outside accountant to perform the annual audit. These are tasks that are necessarily performed by a single corporation on behalf of virtually any affiliated group, regardless of the level of integration that otherwise exists between the members. Consequently, common tax return preparation and common financial statement preparation will not carry any weight in a unitary context.

Intercompany financing has often been held to be substantial evidence of "functional integration." It is important to determine the purpose of the financing. Financing is not a unitary factor when it primarily serves to diversify the corporate portfolio and reduce the risks inherent in being tied to one industry's business cycle. (Tenneco West, Inc. v. Franchise Tax Board (1991) 234 Cal.App.3d 1510, 1532) The Court distinguished such financing from an investment in subsidiaries which functions to make better use of business-related resources through economies of scale, operational integration, or sharing of expertise. The U.S. Supreme Court confirmed that capital transactions must serve an operational rather than an investment function. (*Alliedsignal, Inc. v. New Jersey*, (1992) 504 U.S. -, 119 L.Ed.2d 533, 112 S.Ct. 2251)

Taxpayers may argue that the centralized functions performed by one corporation on behalf of another corporation did not result in any cost savings because the service or product could have been purchased for the same price from an outside source. Even if quantifiable cost savings are not present, the corporations may realize intangible benefits from the centralized functions.

The taxpayer needs to pinpoint the benefits achieved by the "functional integration." Although it is difficult to isolate an intangible benefit such as an assured source of supply, documentation of as many facts as possible surrounding the function will help to demonstrate the benefits and may prevent the taxpayer from minimizing the importance of the function as a unitary factor. Corporate minutes, internal correspondence, reports identifying or justifying the need for centralization, and company newsletters, as well as the website, are all sources that may document the benefits achieved by the centralization.

Please stay tuned for more news and follow the [MichiganStateAndLocalTaxBlog](#) for information as it becomes available.

If you have questions, go ahead and contact me. I would be happy to be of assistance.

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