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How to Licitly Exploit Florida's Unitary Method of Corporate Taxation

STEVEN I. WEISSMAN*

Last year, caught up in the whirlwind of the United States Supreme Court decision in Container Corporation of America v. Franchise Tax Board, the Florida Legislature rushed into law the legal-entity-piercing unitary method of corporate-income taxation with a worldwide tax base. On June 1, 1984 (a year after enactment), last-minute, late-night maneuvering on the final day of the legislative session narrowly failed to accomplish a complete retroactive repeal of the new unitary tax rules. The Florida Senate, in the early afternoon of that day, voted almost unanimously for a bill to repeal the new taxing rules and substitute a potpourri of revenue-raising tax measures. Later in the day, the House of Representatives also voted for complete retroactive repeal, but substituted a one-half percentage point increase in Florida's 5% corporate income tax rate. This measure was then sent back to the Senate and it is reported that the corporate lobbyists, who were pushing hard for repeal of the unitary tax, suddenly switched sides and opposed repeal because of the projected cost of the proposed rate increase. The Senate finally adjourned at approximately 9:40 P.M. without voting on the measure. Meanwhile, Governor Graham has announced that he will not call a special session of the Legislature to consider the matter, because there is no agreement on how to replace the projected lost revenue if the new unitary tax rules are repealed.

According to persistent media reports, displeasure over the new unitary tax rules has been cited by numerous major corporations as a reason for pulling out of, or not locating in, Florida. Professionals who must work with the unitary method have uniformly decried it as unduly complex.

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1. ___ U.S. ____; 77 L.Ed. 2d 545 (1983).
2. Miami Herald, June 2, 1984, page 1, Section A.
and administratively burdensome. Meanwhile, serious questions can be raised as to whether the purpose for enactment of the rules—raising tax revenue—will be realized. These negative aspects of the unitary method have been widely and hotly debated and analyzed and are not deeply pursued in this article. Instead, the purpose of this article is to provide some practical guidance for working with the new rules in order to minimize Florida tax liability.

Unlike most states that have adopted the unitary method, Florida has expanded the apportionment formula so that the sales, property, and payroll factors are computed on a worldwide rather than national basis. Under some circumstances, the rules that apply in the computation of each of these factors are so complex and burdensome that a “taxpayer revolt” is invited; further, the state is woefully short of the manpower needed to assure technical compliance. Some examples of the burdensome rules applicable in Florida are those pertaining to valuation of property on a worldwide basis, determination of income on a worldwide basis using generally accepted accounting principles (“GAAP”), synchronization of different fiscal years of members of the unitary business group, and geographic attributions sales. In part, it is the very complexity of these rules, which have not yet weathered any significant test of the infinite combinations and permutations of their practical application, that affords taxpayers many options. Some of these options are discussed below in the spirit of the well-established and generally accepted principle that a taxpayer has a right to act on his own view of the law, if such a view is honestly held and not obviously untenable.3

Florida's Faulty Definition of Unitary Business

If it is determined that a unitary business exists, then all members of that unitary business group must file a combined report of the income of all segments of the business.4 Certain nonbusiness income is allocated to Florida according to a statutory set of rules.5 Thereafter, a mathematical formula is applied to apportion the business income between Florida and other jurisdictions. The mathematical formula is based on three factors consisting of the proportions of: (i) sales in Florida to sales everywhere; (ii) value of property in Florida to the value of property everywhere; and (iii) total payroll in Florida to the total payroll everywhere. Florida puts a double weight on the sales factor so that the apportionment formula is as follows:6

5. Fla. Stat. §220.16.
A threshold determination is whether the taxpayer is a member of a "unitary business group" and, therefore, required to use the unitary reporting method. "Unitary business group" is defined in Florida Statute Section 220.03(1)(aa):

"Unitary business group" means a group of taxpayers related through common ownership whose business activities are integrated with, are dependent upon, or contribute to a flow of value among members of the group. When direct or indirect ownership or control is 50 percent or more of the outstanding voting stock, the group shall be considered to be a "unitary business group" unless clearly shown by the facts and circumstances of the individual case to be a nonunitary business group. When direct or indirect ownership or control is less than 50 percent of the outstanding voting stock, all elements of the business activities shall be considered in determining whether the group qualifies as a "unitary business group." (Emphasis added.)

The first sentence of the foregoing statute is an attempted codification of case law, and, in general terms, follows the constitutional prerequisites in defining a unitary business group by requiring common ownership and integrated business activities that "are dependent upon, or contribute to a flow of value among members of the group." As a practical matter, this brief definition is of little assistance to the advisor attempting to determine whether a unitary business group exists; in such a case, it is necessary to consult and analyze the case law.

The second sentence of Section 220.03(1)(aa) sets up a presumption that a unitary business group exists if "direct or indirect ownership or control is fifty percent or more of the outstanding voting stock..." of the group. This presumption is unreasonable and contrary to the constitutional guidelines enunciated by the United States Supreme Court in several cases. The mere fact that common ownership is 50% or more forms no basis for a presumption that a unitary business group exists; it is just one of the factors to be considered in making such a determination. The Florida Department of Revenue (the "Department") is apparently aware of this legislative error and has attempted to rehabilitate Section 220.03(1)(aa) by stating in its regulations:

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8. See, e.g., F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico, 458 U.S. 354; 73 L.Ed. 2d 819 (1982).
Unity of ownership is a prerequisite for a business to be unitary. Unity of ownership exists when the business is carried on through controlled subsidiaries. The statute presumes unity of ownership in cases where direct and indirect ownership or control is fifty percent or more. This presumption may be overcome by the facts of the specific case which clearly show the business is not unitary.\(^9\) (Emphasis added.)

Contrary to the Department's regulations, the statute creates a presumption not of mere unity of ownership, but of a unitary business group's existence when the 50% ownership test is met. This legislative flaw creates significant tax reduction opportunities for taxpayers who are familiar with the constitutional constraints imposed on state use of the unitary method. This flaw may allow taxpayers to "elect" unitary reporting when there is 50% common ownership if tax reduction will result even when, under the constitutional guidelines, no unitary business exists.

The tax reduction opportunities inherent in the statutory presumption are illustrated by the following example:

**Example.** Corporation A is incorporated in New York and is engaged in chain store retailing throughout the U.S. A owns all the stock in 20 profitable retailing subsidiary corporations that operate retail stores outside Florida. A operates one retail store in Florida that loses money, and has no other source of income except substantial dividends received from its subsidiaries.

The subsidiaries operate autonomously and independently of A in matters such as selecting merchandise to be sold, store-site selection, advertising, and accounting control. Each has a complete accounting department, its own financial staff, and legal counsel. There is no central purchasing, warehousing, employee training, or exchange of personnel. Each subsidiary is responsible for obtaining its own financing from sources other than A. Corporation A has no separate department that is responsible for overseeing the operations of its subsidiaries.

A elects the directors of each of its subsidiaries and shares some directors in common with them. No major financial decisions, such as the amount of dividends to be paid to A, or the creation of substantial debt, are made without A's approval. A and its subsidiaries prepare all their financial statements on a consolidated basis.

Under the Florida statute, A is presumed to be engaged in a unitary business with the subsidiaries because its ownership of their stock is 50% or more. The Department's regulations further bolster this position, stating:

A taxpayer is generally engaged in a unitary business when all of its activities are in the same general line. For example, a taxpayer which

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operates a chain of retail grocery stores will almost always be engaged in a unitary business. Thus, under the Florida statute and regulations, the above example is a textbook model of a unitary business. According to the Florida position, A's store in Florida would be required to file a combined report with the profitable subsidiaries, and some of the net income would be apportioned to and taxed by Florida.

Contrary to the Florida position, based on a recent decision of the United States Supreme Court, a unitary business does not exist in the above example, and since Corporation A loses money in its Florida store, there is no income subject to tax by Florida. None of the substantial dividend income Corporation A receives from its subsidiaries is allocable to Florida.

The facts in the example are based on *F. W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*, in which the decision of New Mexico's high court that Woolworth was engaged in a unitary business with its subsidiaries was reversed by the United States Supreme Court, which found:

Each of the foreign subsidiaries at issue operates a "discrete business enterprise"... with a notable absence of any "umbrella of centralized management and controlled interaction"... New Mexico, in taxing a portion of dividends received from such enterprises, is attempting to reach "extra-territorial values"... wholly unrelated to the business of the Woolworth stores in New Mexico. As a result, a "showing has been made that income unconnected with the unitary business has been used in the" levy of New Mexico tax... We conclude that this tax does not bear the necessary relationship "to opportunities, benefits, or protection conferred or afforded by the taxing State"... New Mexico's tax thus fails to meet established due process standards.

Woolworth demonstrates that, regardless of any contrary provisions in the Florida statutes or regulations, the taxpayer should—when to its benefit—apply the established constitutional standards in making the initial determination as to whether a unitary business exists.

The fact that it will frequently benefit the taxpayer to take the position that its business is unitary is vividly illustrated by the California case of

10. Id.
12. Fla. Stat. §220.16(e).
14. 458 U.S. at ___; 73 L.Ed. 2d at 832.
Superior Oil Company v. Franchise Tax Board. Superior Oil had overall net earnings of approximately $3.2 million. The company's net income from California sources computed by separate accounting was $10,637,633. Superior Oil was engaged in business in eight states other than California, and during the tax year 1951 it had losses in seven of those states. The taxpayer filed its return in California using the unitary method, which resulted in a total net income from California sources of $1,135,060—$9,502,573 less than the amount determined by separate accounting. The state took the position that Superior Oil was not engaged in a unitary business and that separate accounting was required. The court upheld the taxpayer's determination of income under the unitary method.

Making the Computations

Theoretically, the unitary method is an excellent means of geographically attributing income. But, because the unitary method is horribly complex, it calls for many subjective determinations. Inconsistent with the painstaking recordkeeping and calculations it may demand, the unitary method apportions income among various jurisdictions with a hatchet as opposed to a scalpel. Implicitly recognizing the hatchet effect, the Florida statute provides a savings clause:

If the apportionment methods . . . do not fairly represent the extent of a taxpayer's tax base attributable to this state, the taxpayer may petition for, or the department may require . . . [t]he employment of any other method which will produce an equitable apportionment.16

Understandably, most taxpayers will prefer to construe the new rules in a manner that produces their own equitable apportionment, if that is possible, rather than petition the state for equity. In its regulations, the state has indicated that few deviations will be permitted from the unitary method:

The party . . . seeking to utilize an alternative apportionment method must show by clear and cogent evidence that the regularly applicable formula would result in taxation of extraterritorial values . . . This can be shown only if the regularly applicable formula is demonstrated to operate unreasonably and arbitrarily in attributing to Florida a percentage of income which is out of all proportion to the business transacted in Florida.17

15. 34 Cal. Rptr. 552; 386 P.2d 40 (Cal. 1963).
17. Rule 12C-1.15(6)(d), Florida Administrative Code.
The following are examples of just some of the other areas in which the taxpayer may minimize any tax and the compliance cost of the new rules by exercising enlightened judgment.

**Nonbusiness Income**

The statute defines "nonbusiness income" as income that does "... not arise from transactions and activities in the regular course of the taxpayer's trade or business." The statute also specifies that nonbusiness income does not include income from property acquired, managed, or disposed of as an "... integral part of the taxpayer's trade or business." Since nonbusiness income is not subject to the apportionment formula, when the statute would allocate a particular item to Florida, it is in the taxpayer's best interest to take the position, when tenable, that it is business income. If the item is business income, then it is subject to apportionment and only a portion of it will be taxed in Florida. On the other hand, when the statute would allocate a particular item of nonbusiness income to a jurisdiction other than Florida, the taxpayer would obviously prefer that the item be classified as nonbusiness income.

As shown in the following examples reproduced from the regulations, whether certain items of income are business or nonbusiness may depend solely upon the taxpayer's intentions:

**Example (1):** The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

**Example (2):** The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plan was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

**Example (3):** The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is non-

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18. Fla. Stat. §220.03[1](r).
19. *Id.*
business income and the gain (or loss) on the sale of the building is nonbusiness income.

Example 4: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

Example 5: The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totalling $200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

In Example 1, if the taxpayer had intended to acquire the five-story building for use in its business and also, partially, as investment-rental property, there would be nonbusiness income. In Example 2, if the taxpayer had intended to rent the property indefinitely, but suddenly decided to dispose of it after 18 months, presumably there would be nonbusiness income as in Example 3. Example 4 is self-explanatory, and suggests that the labels used by the taxpayer to characterize its "investment" accounts may be an important factor in determining the character of the income. In Example 5, it seems that the interest income earned on the "extra cash" should, or may, be considered nonbusiness income regardless of the maturity dates of the securities. The foregoing are illustrative of the many situations in which the taxpayer is required to characterize income based upon subjective criteria, and the great extent to which an understanding of the law can shape the calculations.

Maintaining Proper Perspective in Compliance Efforts

Probably the major negative aspect of the unitary method is the taxpayer's cost of compliance. In many cases, this cost far exceeds the difference (whether an increase or savings) between the tax computed under the unitary method and that computed under the separate accounting method. Ironically, this point is best illustrated by the case that provided the stimulus for Florida's enactment of the unitary method with a worldwide tax base—Container Corporation.20

In Container Corporation, the United States Supreme Court upheld California's application of the unitary method of accounting to Container Corporation and its 20 foreign subsidiaries located in four Latin American and four European countries. California applied a 5.5% tax rate to the

portion of the total income of the unitary business group apportioned to the state under its three-factor apportionment formula. The net tax result of California’s inclusion of the subsidiaries as part of the unitary business group was as follows:\textsuperscript{22}

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>1963</th>
<th>1964</th>
<th>1965</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in total unapportioned income of unitary business</td>
<td>$10,477,756</td>
<td>$15,471,559</td>
<td>$14,604,124</td>
</tr>
<tr>
<td>Increase in California tax</td>
<td>$15,304</td>
<td>$33,888</td>
<td>$22,750</td>
</tr>
</tbody>
</table>

One can only speculate as to Container Corporation’s expenses in preparing a California return for its 20 foreign subsidiaries having combined net annual income of between 10 and 15 million dollars, and obtaining all data required to compute the apportionment fraction. However, the cost may have far surpassed the amount of additional tax (which is deductible for federal income tax purposes) paid to the state.

Under the Florida rules, with facts as in Container Corporation, the following steps must be taken to apply the unitary method. First, even if the foreign members of the unitary business group are not required to file U.S. income tax returns, “taxable income” must be computed using GAAP. In order to compute a hypothetical taxable income, depreciation, depletion, employee benefits, and the like must be assumed. All the income of the parent and subsidiaries must be calculated based on a common fiscal year. Regardless of acquisition date, the original unadjusted cost of all real, tangible, and intangible property must be determined. For rented property, a deemed cost is used equal to eight times the annual rent, with several modifications and exceptions. A determination must be made as to which sales are to be attributed to Florida. Finally, all amounts must be expressed in U.S. currency. For a business of any significant size, the costs of such calculations may be prohibitive and absolutely unjustifiable when compared to the amount of tax likely to be involved. In such circumstances, the taxpayer must rely upon estimates. The cost of auditing for the state will, in many cases, be impractical, and the state will generally be forced to rely upon the taxpayer’s estimates. Taxpayers will have to artfully make the computations to avoid incurring $100,000 in accounting fees to calculate a $1.00 tax.

\textsuperscript{22} Container Corporation of America v. Franchise Tax Board, ___ U.S. ___, 77 L.Ed. 2d 545 (1983) at nn. 11 & 12.
Conclusion

To co-exist peacefully with Florida’s new unitary tax rules, the taxpayer needs to understand the constitutional constraints within which the rules must function. To obtain the best results, it is not sufficient to rely solely upon either the Florida statutes or the rules promulgated thereunder. The essence of compliance is the art of balancing the practicalities and costs against the theoretical Florida requirements, which will often prove unworkable. Meanwhile, some taxpayers may find that the new rules actually provide some opportunities to reduce their Florida tax liability.