California Office of Tax Appeals Holds that Divisions of a Corporation Were Not a Unitary Business

Posted November 18, 2026

By Robert S. Horwitz

The California Franchise Tax Board (FTB) has frequently claimed, successfully, that a business that didn't operate in California was unitary with a business that did operate in California. This requires the two businesses to pool their income and deductions, so they are taxed as one business. Where an out-of-state entity sells an interest in an entity it owns that does business in California, the FTB has successfully argued that the businesses are unitary, which results in the out-of-state seller being liable for income tax in California for a portion of the gain from the sale. See *Appeal of Smith*, 2023-OTA-069P. The OTA recently handed the FTB a loss in *Appeal of Western Distributing Company, et al*, 2026-OTA-467P. This blog will not focus on the OTA's legal analysis, but upon the evidence that was presented that convinced the OTA that Western Distributing's beverage distribution division was not unitary with its other divisions.

Background

Western Distributing is an S corporation headquartered in Colorado that conducted its business through 14 divisions. The two largest divisions were Western Beverage (WB) and Western Transportation (WT). WB distributed beverages only in Colorado. WT operated an interstate long-haul trucking business that operated in California. In 2010, Western Distributing sold WB in an asset sale. The FTB determined that WB was a unitary business with Western Distributing's other divisions and that a portion of the gain was allocable to California using the special apportionment formula applicable to trucking companies. As a result, it asserted tax deficiencies against Western Distributing and its shareholders.

The appellants presented their case primarily through the declarations of officers and division managers. The evidence it presented is as follows.

Western Distributing started as a beer distributor in 1930. It began a trucking operation in 1977, originally to pick up and deliver WB's inventory. WT became a separate division in 1986. Since WT was profitable moving goods for third parties, it became an interstate transport business.

Western Distributing's president and CEO, V. Gaines, was a stock car racing enthusiast. He spent approximately 40 weeks out of the year as a professional race car

driver. He had a decentralized management system in which each division operated separately from the others and the managers of each division ran the division independently.

There was no centralized advertising, sales or legal department. Each division conducted its own advertising and sales. Each division controlled its own purchasing with little oversight.

There was a centralized accounting department. Each division had its own accounting/bookkeeping personnel who prepared financial reports. These reports were used by the central accounting department to prepare tax returns and financial statements. The CEO and CFO used the financial reports to monitor the business.

WDC had a credit line secured by WB's accounts. The line of credit was linked to WDC's checking account and was used by WB. WT had its own debt.

WDC had an insurance policy that included general liability coverage and employee benefits coverage for the entire company. Human resources were centralized, including payroll, health and benefits and retirement. Each division, however, made its own hiring and firing decisions.

Each division had one or more vice presidents or managers. They were in charge of the day-to-day management of their divisions. The managers' compensation was based in part on the performance of the division. Several managers submitted declarations supporting WDC's claim that the divisions were managed separately.

WDC also presented evidence that interdivision transactions were at the managers' discretion and were at arms' length prices. WB occasionally hired WT to transport goods to its warehouse at WT's standard rates. WB accounted for less than 1% of WT's gross revenues.

In 2010, WDC sold WB in an asset sale. It reported gain from the sale as non-business income, none of which was apportioned to California. The FTB audited WDC's 2010 California return and apportioned gain from the sale to California on the ground that WDC's divisions were a unitary business.

The OTA's Analysis

The OTA first applied the three unities test. Under the three unities test, there is a unitary business if there is "(1) unity of ownership, (2) unity of operation evidenced by central purchasing, advertising, accounting and management, and (3) unity of use in the centralized executive force and general system of operation." All three unities must exist for businesses

to be unitary. Based on the declarations and testimony presented by the taxpayers, WT and WB were managed independently, with WDC's CEO and CFO exercising "the type of oversight that might be exercised by an investor over a substantial investment." Thus, unity of use did not exist. That the business activities were operated in a single corporate entity with one set of officers and directors does not "necessarily indicate strong centralized management." The OTA found that unity of use did not exist. Thus, WT and WB were not a unitary business under the three unities test.

The other unitary business test is the contribution or dependency test. For businesses to be unitary under this test, one business must be dependent upon or contribute to the operation of the other business,otherwise, the businesses must be considered as separate. The FTB pointed to WDC treating its divisions as unitary in prior year returns. The OTA gave this little weight given that WDC made errors in reporting the sale on its return. Given the lack of (a) common advertising, (b) significant intercompany sales, (c) centralized management and (d) other indications of dependency or contribution, the OTA concluded that the taxpayers had met their burden of showing that the contribution or dependency test was not met.

Finally, the OTA addressed a claim the FTB raised for the first time on appeal: that WDC had a "tax benefit" from reporting deductions from WB as part of a unitary group on prior returns. Since this issue was raised by the FTB for the first time on appeal, it had the burden of proof. Since it did not present any evidence to support its claim, it lost this issue.

What We Can Learn from Western Distributing

Although *Western Distributing Company* had an unusual fact pattern, there are several lessons that can be learned. One is the importance of having good facts. Another is to have declarations from several credible witnesses that support the taxpayer's factual claim. The OTA allows parties to submit declarations in lieu of live testimony, as long as they are provided to the other side in sufficient time to allow the other party to submit written questions to the declarant. See, sec. 30214 of the California Code of Regulations. If the taxpayers in this case had relied solely on just a declaration from the CEO, the OTA may well have considered it self-serving and held that the taxpayers failed to meet their burden of proof. So, if you have supporting third-party declarations, that evidence will have a positive impact on the OTA. Third, have a theme that the witnesses' testimony and declarations support-in this case, the consistent (and supported) theme was that the divisions of WDC were managed and operated independently of each other. While these lessons will not ensure that your client prevails before the OTA, it will increase the chances for success and, if nothing else, can may help get a favorable settlement from the FTB Settlement Bureau.

Robert S. Horwitz *is a Principal at Hochman Salkin Toscher Perez P.C., former Chair of the Taxation Section, California Lawyers' Association, a Fellow of the American College of Tax Counsel, a former Assistant United States Attorney and a former Trial Attorney, United States Department of Justice Tax Division. He represents clients throughout the United States and elsewhere involving federal and state administrative civil tax disputes and tax litigation as well as defending clients in criminal tax investigations and prosecutions. In 2022, the Tax Section of the California Lawyers Association awarded him the Joanne M. Garvey Award for lifetime achievement in and contributions to the field of tax law. Additional information is available at http://www.taxlitigator.com.*

For more information, please contact Robert at horwitz@taxlitigator.com

This article provides general information and is not legal or tax advice.