SUBSTANCE OVER FORM: REFINEMENT OF THE UNITARY BUSINESS DOCTRINE IN *MEADWESTVACO CORP. V. ILL. DEP'T OF REVENUE*, 553 U.S. 16 (2008)

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I. INTRODUCTION

While there are many competing conceptions of what the function of the law is in our society, since time immemorial courts have sought to provide fair treatment to all. It serves as no surprise, therefore, that this search for fairness has included a struggle for fairness in taxation. Through the unitary business principle, the Supreme Court has attempted to articulate a fair way for state governments to tax multi-state businesses without either overburdening them with multiple taxation nor permitting the state to violate the due process rights of businesses through the use of their tax power. This is a delicate balancing act and, as *MeadWestvaco Corp. v. Illinois Department of Revenue*[1] shows, one the Court still struggles to maintain.

MeadWestvaco raises the question of whether states may tax multi-state corporations on a new conceptual basis: the function an asset serves within a business. Specifically, the Illinois Department of Revenue attempted to persuade the Court to allow it to tax the gain from the sale of an asset located in Illinois, owned by a nondomiciliary corporation, because the asset served an operational function within the nondomiciliary's business. In passing on this issue, the Court continued its refinement of a doctrine that dates back to the dawn of the railroad age and appears likely to evolve further still.

To examine this issue, Section II will first discuss the history of the unitary business principle with a view to teasing out its essential elements. Section III will then describe the specific facts of *MeadWestvaco* and lay out the Court's holding. Section IV will conclude with an analysis of the impact of this latest development in the principle along with a discussion of some possible future developments in the field suggested by the opinion and

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1. MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16 (2008).

accompanying concurrence. The unitary business principle is not a perfect solution to the problems of interstate taxation, as this note will explore. In the end, however, *MeadWestvaco* makes a needed clarification of this vital doctrine and may lead to further developments in this area of the law.

II. HISTORY AND BACKGROUND OF THE UNITARY BUSINESS PRINCIPLE

The unitary business principle is a broad doctrine rooted in a few key requirements. The principle permits a state to tax a proportion of the total income of an out-of-state corporation.[2] While there is no need for a physical relationship or even a unitary relationship between two businesses, there must be some connection between the taxing state and the value it seeks to tax.[3] This must be coupled with a rational relationship between the corporation's activities in the taxing state and the value attributed to the corporation for tax purposes.[4] To find a unitary business requires more than a passive investment or a single isolated business operation, and it must be impossible to determine the amount and nature of the flow of value between the asset in the taxing state and the out-of-state company in question.[5]

The unitary business principle has a lengthy history which serves as the background for the Court's opinion in *MeadWestvaco*. This history began in the age of rail and addressed an issue of basic fairness: the portion of income from a nondomicillary which a state could tax. A brief review of this history follows.

A. Purpose and Origin of the Unitary Business Principle

In *MeadWestvaco* the Court based a large portion of its opinion on the history of the unitary business principle.[6] A similar historical review was carried out in *Allied-Signal, Inc. v. Director, Division of Revenue*. In *Allied-Signal*, Justice Kennedy began by describing the fundamental constitutional barriers to interstate taxation that the principle can overcome. The first is the Commerce Clause, which prohibits interstate taxation because it would subject businesses to multiple taxation.[7] The second is the Due Process Clause of the

2. *See* ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 316 (1982).
3. *See* Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 436–37 (1980); Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 221 (1897).
4. *Mobil Oil Corp.*, 445 U.S. at 436–37.
5. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 166 (1983).
6. MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16, 24-28 (2008).
7. Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768, 777–78 (1992).

Fourteenth Amendment, which requires some connection between a state and any activity it seeks to tax (making a mere link between a state and a potential taxpayer insufficient).[8]

These two prohibitions came to the fore in the nineteenth century when interstate businesses such as railroads and telegraph companies presented states with the problem of how to fairly tax them: "[a] State often cannot tax its fair share of the value of a multistate business by simply taxing the capital within its borders."[9] This problem led states to adopt what came to be known as the "unit method of valuation."[10] "By 1895, the common practice was to assess that portion of the capital stock of railroads, telegraph, and certain transportation companies represented by the proportion of the mileage of routes or lines in the state to mileage everywhere that the company conducted its business."[11]

1. Adams Express Co. v. Ohio State Auditor

One of the first major cases to address this problem was *Adams Express Co. v. Ohio State Auditor*.[12] There the Supreme Court restated its prior holding that a state may tax in-state property belonging to railroads, sleeping-car companies, and telegraph firms which extend through multiple states as well as a fair portion of the entire company.[13] This was permitted because the physical property used in the state to carry on the company's business (railroad tracks, telegraph poles, etc.) possessed value partly attributable to property and capital located outside the state which was therefore subject to taxation.[14] The Court would later come to refer to this infusion of capital from outside the state as "contributions to income resulting from functional integration, centralization of management, and economies of scale."[15] In *Adams Express* the unitary business principle was stated in a general fashion. In order to tax a portion of the interstate corporation's assets, the Court required not a physical connection between states but rather "unity in the use of the entire property for the specific purpose."[16]

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8. *Id*. at 778.
9. *MeadWestvaco*, 553 U.S. at 26.
10. James H. Peters & Benjamin F. Miller, *Apportionability in State Income Taxation: The Uniform Division of Income for Tax Purposes and* Allied-Signal, 60 TAX LAW. 57, 60 (2006).
11. *Id.*
12. Adams Express Co. v. Ohio State Auditor, 165 U.S. 194 (1897).
13. *Id.* at 220–21.
14. *Id.*
15. Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 437 (1980).
16. *Adams Express Co.*, 165 U.S. at 221.

2. Underwood Typewriter Co. v. Chamberlain

The unitary business principle was broadened in *Underwood Typewriter Co. v. Chamberlain* to permit the taxation of corporate income.[17] This case recognized that corporate revenue could be derived from a process beginning with manufacture of a product in one state and ending with sales in multiple others.[18] Taxation of corporate income was thus justified by the Court on the theory that the state was only taxing profit earned within the state, with apportionment being a means to substitute for the impossible taxation of the exact profit derived within the state's borders.[19] Thus in *Bass, Ratcliff & Gretton v. State Tax Commission*, the state of New York was permitted to tax an English ale manufacturer which sold its product in the state.[20] New York was held to be justified in taxing a portion of the company's profits because the distribution and manufacture of ale constituted a unitary business.[21]

B. Modern Developments in the Definition of a "Unitary Business"

Having considered the core concepts and underlying policies of the unitary business principle, it is now appropriate to consider three modern cases invoking it. In these cases the Supreme Court attempted to preserve the principle as states attempted to expand their tax powers. In so doing the Court simultaneously sowed the seeds of what would come to be known as the operational function test, a doctrine which the Court would finally confront in *MeadWestvaco*.

1. ASARCO, Inc. v. Idaho State Tax Commission

More recent Supreme Court decisions have dealt with the problem of what constitutes a unitary business.[22] One of these is *ASARCO, Inc. v. Idaho State Tax Commission.*[23] *ASARCO* is notable as one of the first cases in which the Court struck down a state attempt to tax apportionable income without the

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17. Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).
18. *Id*. at 120–21.
19. *Id*.
20. Bass, Ratcliff & Gretton v. State Tax Comm'n, 266 U.S. 271 (1924).
21. *Id.* at 282.
22. MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16, 26-28 (2008). *See also* Allied-Signal v. Dir., Div. of Taxation, 504 U.S. 768, 780 (1992).
23. ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982).

use of the unitary business principle.[24] An auditor for Ohio found that ASARCO did not form a unitary business with five companies that paid it dividends, but the auditor still treated the dividends (along with income from capital gains and interest) as part of ASARCO's total apportionable income.[25] The Supreme Court began by detailing *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* in which the Court recognized that the Due Process Clause mandates "a minimal connection between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise."[26] As long as the activities taking place both in and out of the taxing state were part of a single unitary business, however, taxation by apportionment of income generated in another state does not violate the Due Process Clause.[27] The Court went on to observe that "where the business activities of the . . . payor have *nothing to do* with the activities of the recipient in the taxing State, *due process considerations might well preclude apportionability, because there would be no underlying unitary business.*"[28]

In *ASARCO*, Idaho asked the Court to broaden the definition of a unitary business. It sought to include income from intangible property "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business."[29] The Court found this to be a step too far because almost any activity a corporation undertakes would fall within the definition proposed.[30] The Court then found that the dividends did not bear the required rational relationship between the assets and the taxing state and held that all of the income in question could not be taxed under the Due Process Clause.[31]

2. Container Corp. of America v. Franchise Tax Board

In *Container Corp. of America v. Franchise Tax Board* [32] the Court elaborated on the necessary connection between the out-of-state and in-state activities of the company to be taxed: in order for a business to be unitary,

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24. *Allied-Signal Inc.,* 504 U.S. at 780. The other initial case, *F.W. Woolworth Co. v. Taxation and Revenue Dep't of N.M.*, 458 U.S. 354 (1982), was decided on the same day. *Allied-Signal, Inc.*, 504 U.S. at 780.
25. *ASARCO, Inc.*, 458 U.S. at 313.
26. *Id.* at 316 (quoting Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 436–37 (1980)).
27. *Id.*
28. *Id.* at 317–18 (quoting *Mobil Oil Corp.*, 445 U.S. at 441–42) (italics in original).
29. *Id*. at 326 (quoting Brief of Appellee at 4, ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) (No. 80-2015), 1982 WL 608688).
30. *Id.*
31. *Id.* at 328–29.
32. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).

there must be "some sharing or exchange of value not capable of precise identification or measurement–beyond the mere flow of funds arising out of a passive investment or a distinct business operation–which renders formula apportionment a reasonable method of taxation."[33] Secondly, the Court observed that the principle is, in fact, a broad one which permits a number of variations so long as they are faithful to the basic underpinnings of the principle.[34] Finally, the Court emphasized that a unitary business requires "a flow of *value*, not a flow of goods."[35]

3. Allied-Signal, Inc. v. Director, Division of Taxation

A final important opinion is *Allied-Signal, Inc. v. Director, Division of Taxation*.[36] That case dealt primarily with the continuing viability of the unitary business principle as it was expressed in *ASARCO* and its sister case, *F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico.*[37] As a preliminary matter, the Court noted that dividends and capital gains are treated the same for constitutional purposes.[38] The Court also noted that in *F.W. Woolworth Co.* it had used the three factors indicative of a unitary business noted in *Mobil Oil* (functional integration, centralization of management, and economies of scale) to determine whether a unitary business existed.[39]

The Court addressed two suggestions for alterations to the unitary business principle. New Jersey proposed an entirely new test which would subject the entire income of any corporation doing any business in the state to apportionment because common ownership rendered the business transaction part of the corporation's unitary business.[40] The underlying theory behind this innovation was that corporations view their holdings as a single group of assets and therefore there is no real difference between investment assets and assets used for operational purposes.[41] The Court disagreed with New Jersey, holding that the difference between operational and investment assets is "the

33. *Id.* at 166.
34. *Id.* at 167.
35. *Id.* at 178 (emphasis in original).
36. Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768 (1992).
37. *Id.* at 777.
38. *Id.* at 773, 780.
39. *Id.* at 781.
40. *Id.* at 784.
41. *Id.*

relevant unitary business inquiry" which is required to give substance to the limits of the Commerce and Due Process clauses.[42]

After addressing New Jersey's replacement for the unitary business principle, the Court turned to a more moderate proposal by *amici curiae* to alter the existing principle.[43] In advocating for the adoption of the definition of business income provided in section one of the Uniform Division of Income for Tax Purposes Act (UDITPA) as the Court's standard for apportionment, *amici* argued that there is no constitutional requirement of a unitary business relationship when a state seeks to apportion the income of a payor company's investment in a payee.[44] In retaining the unitary business principle, the Court agreed that "the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. . . . What is required instead is that the capital transaction serve an operational rather than an investment function."[45]

III. EXPOSITION OF THE CASE

As the preceding section demonstrated, the unitary business principle is a complex doctrine. This section deals with the Supreme Court's response to a potential new branch of an already gnarled and difficult concept.

A. Facts

MeadWestvaco found its way to the Supreme Court due to the 1994 divestiture of Lexis/Nexis by MeadWestvaco's predecessor in interest, Mead Corp.[46] Lexis/Nexis ("Lexis"), originally launched in 1973, eventually grew to produce $800 million dollars in Illinois income between 1988 and 1993 and accounted for twenty-one percent of Mead's Illinois income for those years.[47] Lexis was subject to some oversight by Mead, which primarily involved approving the annual business plan and large transactions such as mergers and acquisitions and capital expenditures.[48] Mead controlled Lexis's free cash (which was reinvested into Lexis at Mead's direction) and on one occasion

42. *Id.* at 784–85.
43. *Id.* at 786 (discussing *amicus curiae* briefs by the Multistate Tax Commission and Chevron Corp.).
44. *Id.*
45. *Id.* at 787 (quoting Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 180 n.19 (1983)).
46. MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16, 19-20 (2008).
47. *Id.* at 21. Mead made $3.8 billion in total Illinois income during this period. *Id.*
48. *Id.* at 22.

leased needed equipment to Mead.[49] In many other ways Lexis was largely autonomous of Mead. It maintained separate facilities for manufacturing and distribution, separate sales facilities, and separate departments for marketing, human resources, accounting, and legal affairs.[50]

Lexis was a wholly owned subsidiary of Mead until 1980, when it merged with Mead for tax reasons.[51] Mead then split off Lexis in 1985 and merged with it a second time in 1993, with tax reasons motivating both changes in Lexis's structure.[52] Throughout the period from 1988 to 1994 Mead treated Lexis as a part of its unitary business for Illinois tax purposes.[53] This was done as demanded by the State of Illinois, which had threatened litigation on the issue.[54] However, Mead included Lexis as a business segment in both annual reports and filings with regulatory agencies.[55] Mead also described itself as an electronic publisher and developer of an information retrieval service in the same reports and filings.[56]

When Mead sold Lexis it failed to list the proceeds of the sale on its 1994 Illinois tax filings, concluding that the proceeds from the sale were nonbusiness income and thus not taxable by Illinois under the terms of the Illinois Income Tax Act ("the Act").[57] The Illinois Department of Revenue ("IDOR") found that Mead should have treated the income from the sale of Lexis as a capital gain under the Act, making the income apportionable by Illinois.[58] In 1994,

> [the Act] defined 'business income' as 'income arising from transactions and activity in the regular course of the taxpayer's trade or business,' as well as 'income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.'[59]

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49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.* at 20. Mead asserted that tax on the proceeds were payable instead to Mead's corporate domicile, Ohio. *Id.*
58. *Id.*
59. *Id.* at 21 n.2 (quoting 35 ILL. COMP. STAT. ANN. 5/1501(a)(1) (West 1994)).

IDOR assessed a total additional tax liability, including penalties, of approximately four million dollars. Mead paid the amount assessed.[60] In 2001 Mead filed suit challenging IDOR's classification of the proceeds from the Lexis sale as business income subject to apportionment.[61]

B. Procedural Posture

The trial court found that Lexis was not part of Mead's unitary business, but nevertheless found an Illinois tax liability, reasoning that the gain from the sale was apportionable because Lexis was "essential to the taxpayer's regular trade or operations."[62] Mead appealed and the Illinois First District Court of Appeals affirmed.[63] The appellate court recognized two grounds for apportioning capital or intangible income of a nondomiciliary corporation: the unitary business principle and the "operational function test."[64] The operational function test permits apportionment where an asset served "an operational function rather than an investment function" within the business in question.[65] Determination of whether an asset is operational is based on "objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State."[66] The First District declined to decide whether Mead and Lexis formed a unitary business, choosing to focus instead on whether Lexis served an operational function in Mead's business.[67] It found that Lexis did serve an operational function because it was wholly owned, and partially controlled, by Lexis and also because Mead touted itself as an electronic publisher and information retrieval service developer, thereby identifying itself with the trade Lexis was engaged in.[68] Mead then appealed to the United States Supreme Court after the Illinois Supreme Court declined review.[69]

MeadWestvaco argued in its brief to the Supreme Court that the appellate court had erred in finding that Lexis served an operational function within Mead's unitary business because the focus of its analysis was on Lexis's

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60. *Id.* at 21.
61. Mead Corp. v. Dep't of Revenue, 861 N.E.2d 1131 (Ill. App. Ct. 2007), *overruled by* MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16 (2008).
62. *MeadCorp.,* 861 N.E.2d at 1137 (quoting Mead Corp. v. Dep't of Revenue, No. 00 CH 7854, 2000 WL 35587638 (Ill. Cir. Ct. Mar. 18, 2003)(mem.)).
63. *MeadWestvaco*, 553 U.S. at 23.
64. *Mead Corp.*, 861 N.E.2d at 1139–40.
65. *Id.* at 1139.
66. *Id.* (quoting Hercules, Inc. v. Dep't of Revenue, 753 N.E.2d 418, 426 (Ill. App. Ct. 2001)).
67. *MeadWestvaco*, 553 U.S. at 23.
68. *Id.*
69. *Id.* at 24.

connection to Mead as a taxable business rather than on the sale itself as a taxable activity.[70] MeadWestvaco argued that the operational function test permits taxation of "income or value from [a] non-unitary asset or investment when that income or value is used in a regular, on-going operational capacity by the parent's unitary business within the taxing State."[71] IDOR's brief to the Court pointed out that Mead's manipulation of Lexis's form of ownership for tax advantage was similar to the act of purchasing products from Lexis at below-market prices, a type of activity that IDOR argued was an operational function.[72] IDOR also argued that the operational function test was not the narrow exception to the unitary business principle that MeadWestvaco claimed and that the two concepts were not mutually exclusive, permitting the same evidence to be used to show the presence of a unitary business and an operational function.[73] While MeadWestvaco argued that Lexis was a passive investment, IDOR argued that the degree of control exercised by Mead over Lexis was more typical of running a business than making an investment.[74]

C. Holding and Reasoning

The arguments of the parties in their briefs suggest that the Court would take the opportunity presented by *MeadWestvaco* to fine tune the operational function test. As discussed below, however, the Court instead turned in a somewhat unexpected direction.

1. Holding

The Supreme Court's decision, written by Justice Alito, did not directly address the arguments of the parties but rather touched on the very existence of the operational function test as an independent ground for income apportionment.[75] The Supreme Court held that the appellate court erred in permitting apportionment based on the function Lexis served in Mead's unitary business because finding such a function should only be considered as a step towards finding an asset to be a unitary part of a business.[76]

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70. Brief of Petitioner at 17–18, *MeadWestvaco*, 553 U.S. 16 (No. 06-1413), 2007 WL 3276500.
71. *Id.* at 31.
72. Brief for Respondents at 41, *MeadWestvaco*, 553 U.S. 16 (No. 06-1413), 2007 WL 4244682.
73. *Id.* at 41–43.
74. *Id.* at 44–45.
75. *MeadWestvaco*, 553 U.S. at 27-30.
76. *Id.* at 29-30.

2. Historical Overview

The discussion begins by briefly reciting basic ideas underlying the unitary business principle, noting that it permits taxation of unitary businesses but not taxation of "out-of-state values . . . derive[d] from unrelated business activity [of an isolated asset]."[77] Justice Alito then provides an overview of the history of the unitary business principle, beginning with its origins in the 1870s.[78] He briefly covers the expansion of the doctrine from its original purpose of providing a way to tax railroads to allowing apportionment of intangibles including net income and dividends.[79] A major portion of this historical overview is devoted to the Court's decision in *Allied-Signal, Inc. v. Director, Division of Taxation*.[80] That decision reaffirmed the continuing usefulness of the unitary business principle and emphasized the flexibility of the doctrine.[81] In *Allied-Signal*, echoing its earlier decision in *Container Corp. of America v. Franchise Tax Board,* the Court stated that even where there is no unitary business formed between a payor and payee "an asset could form part of a taxpayer's unitary business if it served an 'operational rather than an investment function' in the business."[82] Justice Alito provides an example of the Court's logic in application: a state could include a short-term bank deposit within the apportionable income of a nondomiciliary corporation when the interest from the deposit served as working capital within that corporation's unitary business. No unitary business relationship is needed between the corporation and the bank.[83]

3. Clarification of the Operational Function Test

Allied-Signal and *Container Corp* provide the core of Justice Alito's argument.[84] The history of the unitary business principle, he argues, demonstrates that the language of *Allied-Signal* and *Container Corp.* was not intended to be read as allowing a new ground for income apportionment.[85]

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77. *Id.* at 25 (quoting Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768, 773 (1992) (internal citations omitted).
78. *Id.* at 26.
79. *Id.*
80. *Id.* at 26-28.
81. *Id.* at 28.
82. *Id.* (quoting Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768, 787 (1992)).
83. *Id.*
84. *Id*. at 26-29.
85. *Id.*

Instead, "[t]he concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the payor and payee."[86] Determining whether an asset serves an operational function is only a step towards the conclusion that the asset in fact is a unitary part of a business as opposed to an isolated asset which cannot be apportioned.[87] To further illustrate his reasoning Justice Alito turns to the 1955 case of *Corn Products Refining Co. v. Commissioner*.[88] The Court had then held that corn-futures-contracts used by the petitioner as a hedge against a rise in the price of corn were an operational asset.[89] The futures-contracts were a unitary part of the business even without a unitary business relationship between the corn refiner and the counterparty to the hedge.[90] Because the operational function test does not allow for income apportionment when there is not a unitary business, the appellate court's decision on that ground was error.[91] As the appellate court had not addressed the issue of whether Lexis formed a unitary business relationship with Mead, the case was remanded for the consideration of that question.[92]

4. Alternative Grounds for Affirming Appellate Court Rejected

Two other issues were addressed in the Court's consideration of the case, though the Court addressed neither in detail. First, Justice Alito notes that IDOR and *amici curiae* urged the Court to uphold the appellate court's decision permitting apportionment of the income from the Lexis sale on a different apportionment theory.[93] They wished the Court to permit apportionment of intangible assets based on the connection between a capital asset and the state seeking to tax it.[94] Justice Alito declines to address this argument because it had not been posed before the lower courts and was not addressed by IDOR.[95] He also notes that Ohio and New York had both adopted the alternative method of apportionment being proposed and that they

86. *Id.* at 29.
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.* at 30.
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.* at 29-31.

had neither been alerted to the fact that it may come before the Court nor presented an *amicus* brief on the issue. [96]

5. Concurring Opinion–Justice Thomas on the Court's Unitary Business Jurisprudence

Another issue was raised by Justice Thomas in his concurrence.[97] Despite joining the majority he questions whether the Due Process and Commerce clauses in fact prohibit taxation of "extraterritorial values" as the Court has held they do.[98] He first states that the negative Commerce Clause should not bar such taxation as "this Court's negative Commerce Clause jurisprudence has no basis in the Constitution and has proved unworkable in practice."[99] Turning to the Due Process Clause, Justice Thomas agrees that some minimal connection is needed between a state and whatever thing it attempts to tax in order for the tax in question to be valid under the Fourteenth Amendment.[100] He nevertheless believes that additional limitations on interstate taxation would "require us to read into the Due Process Clause yet another unenumerated, substantive right."[101] In a final critique, Justice Thomas observes that the Court's requirement that a tax must bear a rational relationship to the thing taxed comes close to becoming a judgment on whether a state's tax is excessive.[102] He believes this amounts to reading a right to proportionate taxation into the Fourteenth Amendment and is a de facto regression to the line of precedents begun by *Lochner v. New York*.[103] This is unnecessary, he argues, as Congress has the power to regulate income apportionment under the Commerce Clause.[104] In spite of all these objections, he concurs with the majority's decision because the Court's authority to rule on issues of income apportionment was not questioned by either party.[105]

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96. *Id.* at 31.
97. *Id.* at 32-34.
98. *Id.*
99. *Id.* at 33 (quoting United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth., 550 U.S. 330, 349 (2007) (Thomas, J., concurring in judgment)).
100. *Id.*
101. *Id*.
102. *Id.*
103. *Id.* at 34.
104. *Id.*
105. *Id.*

IV. ANALYSIS

The Court's opinion in *MeadWestvaco* is difficult to parse. Justice O'Connor has noted that the definition of "operational function" is vague.[106] This case, though it does so very briefly, correctly rejects the operational function test as a separate ground of apportionment. The Court's decision is proper because it demonstrates that the operational function test and the three traditional factors applied to determine a unitary relationship are effectively the same test specifically applied in different scenarios.

The opinion is not, however, without its problematic implications. The Court's logic raises the possibility of a new loophole in interstate business tax apportionment. Simultaneously, the asset-to-state relationship test proposed by *amici* could, if later adopted by the Court, serve as an attractive way to stop short what may otherwise be a fundamentally unfair hobbling of the ability of the states to tax nondomicillary businesses. The primary message of *MeadWestvaco* is an old one: "the linchpin of apportionability in the field of state income taxation is the unitary-business principle."[107] While the Court's adherence to the principle is laudable, the application of that principle may one day lead to the exact opposite of the results it was intended to achieve.

A. The Changing State of the Operational Function Test

The holding in *MeadWestvaco*, on its face, is the end of any use of the operational function test as a ground to apportion income apart from the other elements of the unitary business doctrine. However, it is somewhat unclear what the overall status of the test is. One area of uncertainty concerns whether the operational function test forms a part (but only a part) of a broader analysis under the unitary business doctrine. The text of the opinion itself appears to take a neutral position, declaring that application of the test is "instrumental to the constitutionally relevant conclusion that the asset was a unitary part of the business . . . rather than a discrete asset to which the State [has] no claim."[108] This statement could be read as either calling for, or simply allowing the use of, the operational function test as a step in determining whether a unitary business is present. Another interpretation was adopted by Jordan Goodman, who reads the opinion as saying that "[the lower courts], having concluded that Mead and Lexis/Nexis were not unitary, should never

106. Peters & Miller, *supra* note 10, at 158.
107. Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 439 (1980).
108. *MeadWestvaco*, 553 U.S. at 29-30.

have considered whether Lexis/Nexis served an operational purpose."[109] The Court, Goodman says, "suggests that the operational functional test is really just a proxy for the unitary business principle . . . applied when the asset in question is something other than a separate business (such as short-term deposits or futures-contracts)."[110] According to Goodman, *MeadWestvaco* stands for the proposition that "gain on the sale of a business is to be evaluated solely by reference to the unitary criteria of functional integration, centralized management, and economies of scale."[111]

Goodman's interpretation is supported by the opinion. This support includes the Court's use of "payor-payee" language in describing situations in which no unitary relationship is required for the existence of a unitary business and the exclusive use of such transactions in the examples given in the opinion.[112] Further support is derived from the Court's specific statement that "[w]here, as here, the asset in question is another business, we have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale."[113] The specific reference to application of the test to businesses suggests that a unitary relationship is required in these circumstances but not necessarily where other assets are concerned. This is why Goodman states that, so far as businesses are concerned, state business taxation may be avoided merely by showing that there is no unitary relationship between the business in question and the taxpayer.[114] Goodman, in short, views the three traditional factors as the sole component of the unitary business principle as applied to businesses which are simultaneously assets of taxpayers.

It is at this point that Goodman's interpretation becomes interesting. The opinion states unequivocally that a unitary relationship is not needed in order to allow constitutional income apportionment with regard to some assets that are *not* businesses. The opinion is equally clear that a unitary relationship is required when the asset in question is a business. Yet the Court denies use of the test as a *separate* ground of apportionment in relation to those businesses. The logical implication of Goodman's reading, then, is that the operational function test operates when one type of asset (intangibles) is at issue and the traditional three factors are considered when another type (businesses) is being considered. Charles Trost and Paul Hartman take a more restrained reading

109. Jordan M. Goodman, *U.S. Supreme Court Rejects Application of Operational Function Test in the Sale of a Division*, J. MULTISTATE TAX'N & INCENTIVES, Sept. 2008, at 48.
110. *Id*.
111. *Id.*
112. *See MeadWestvaco*, 553 U.S. at 29.
113. *Id.*
114. Goodman, *supra* note 109, at 48.

of the decision, noting that its holding renders operational function analysis irrelevant if there is no unitary relationship between a business division and a parent.[115] This lends further credence to the idea that the two tests accomplish the same purpose. This idea will be discussed in detail in the following section.

B. The Operational Function Test as Integrated Component of Unitary Business Analysis

In its opinion in *Mead Corp. v. Department of Revenue*, the Illinois First District Court of Appeals relied on *Allied-Signal* for a statement of the operational function test.[116] Applied by the First District in its earlier decision, *Hercules, Inc. v. Department of Revenue*, the test examines the "objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State."[117] This was the phrasing of the test before the Supreme Court in *MeadWestvaco* and was presumably the phrasing rejected as a separate apportionment ground in the Court's opinion. This is an interesting point to consider given that the test appears to capture the essence of the unitary business principle.

1. The Unitary Business Principle-Foundational Considerations

As has been previously discussed, the purpose of the unitary business principle is to allow states to tax a fair share of a nondomiciliary's income in recognition of the fact that the corporation as a whole is worth more than any individual asset which comprises it.[118] *MeadWestvaco*, by mentioning specifically that the three traditional factors apply when determining if a required unitary relationship exists, implies that this test does not apply to other types of assets. Therefore something else is apparently required when a unitary relationship is not required. This is not likely to be contained in some simple formula given the Court's assertion that "any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach."[119] This suggests a "soft"

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115. CHARLES A. TROST AND PAUL J. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION § 10:30 (2d ed. 2008).

116. Mead Corp. v. Dep't of Revenue, 861 N.E.2d 1131, 1139 (Ill. App. Ct. 2007).

117. *Id.* (quoting Hercules, Inc. v. Dep't of Revenue, 753 N.E.2d 418, 426 (Ill. App. Ct. 2001)).

118. *MeadWestvaco*, 553 U.S. at 26.

119. Allied-Signal Corp. v. Dir., Div. of Taxation, 504 U.S. 768, 785 (1992) (quoting Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 167 (1983)).

definition of a unitary business commensurate with the flexibility of the Court's approach.

Viewed in this light, it is intriguing that in *Allied-Signal* the Court refers to the operational function test as, in the case of intangible assets, "necessary if the limits of the Due Process and Commerce Clauses are to have substance in a modern economy."[120] It is even more intriguing that the Court states that capital transactions must have an operational function within the taxpayer's business even when no unitary relationship with that business is required.[121] A test so important to determining the unitary business status of intangibles must rest on some bedrock of the unitary business doctrine. The Court goes on to suggest what this bedrock is when it states that "[i]n order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to [those carried out in the taxing] State."[122] In *Exxon Corp. v. Wisconsin Department of Revenue*, the Court stated that whether the income earned is related to activities conducted in the taxing state is determined by an economic analysis of what constitutes a unitary business.[123] This analysis is focused on "the underlying activity, not . . . the form of investment."[124]

2. The Operational Function Test and the Unitary Business Principle

If the function of the unitary business principle is to determine the relationship between an economic activity and a potential taxpayer, then the operational function test definitely fulfills that function. Its focus on the *objective characteristics* of the asset's *use* is evocative of the economic analysis called for in *Exxon*, while the concurrent focus on the relationship to the taxpayer and its activities in the taxing state recalls the language in *Exxon*, quoted in *Allied-Signal*, stating that if there is no sufficient relationship between income and in-state activity there can be no apportionment. Indeed, the congruence between the concepts underlying the unitary business principle and the operational function test is such that one could say that the test is merely the specific application of those principles to the context of intangible assets. No wonder, then, that the Court should have regarded the test as constitutionally necessary in *Allied-Signal*.

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120. *Id.*
121. *Id.* at 787.
122. *Id.* (quoting Exxon Corp. v. Wis. Dept. of Revenue, 447 U.S. 207, 223 (1980)) (brackets in original).
123. *Exxon*, 447 U.S. at 223–24.
124. Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 440 (1980).

Having analyzed the relationship between the operational function test and the unitary business principle, it is now possible to analyze the lone problem with Jordan Goodman's analysis of the *MeadWestvaco* holding: his finding that the operational function test is "a proxy of the unitary business principle."[125] Goodman concluded that *MeadWestvaco* stands for the proposition that the unitary business principle requires only the presence of functional integration, centralization of management, and economies of scale as between an asset which is a business (an "asset business") and a taxpayer to permit the state in which the asset is found to apportion the taxpayer's income. This is a correct interpretation because, as Trost and Hartman observe, the presence of the three factors obviates the operational function inquiry. At heart, the two tests accomplish the same purpose. Functional integration, centralization of management, and economies of scale all relate, in essence, to the economic function of an asset business and its relationship both to the taxpayer and to the activities the taxpayer carries out in the state attempting to levy tax.

The question remains, though, as to why the Court should require the three traditional factors be met if the two tests are essentially equivalent. The first reason to suggest itself is that the three traditional factors are well-tailored to their function of analyzing the unitary nature of asset businesses. Several unitary business cases applying the factors illustrate this point. *Butler Bros. v. McColgan*, an early case dealing with the three traditional factors, dealt with California's attempt to tax an Illinois dry goods manufacturer with distribution centers in seven states.[126] *F.W. Woolworth Co. v. Taxation and Revenue Department of State of New Mexico* applied the factors to the relations of Woolworth and four of its subsidiaries.[127] *ASARCO Inc. v. Idaho State Tax Commission* dealt with dividends and capital gains from five of ASARCO's subsidiaries.[128] Finally, *Allied-Signal* dealt with the possible unitary relationship between ASARCO and Allied-Signal's predecessor-in-interest.[129]

In each of the previously mentioned cases the relationship was between a potential taxpayer and either a subsidiary or one of the taxpayer's operational units. The repeated application of the three traditional factors to such cases may indicate that the Court regards these three factors as a good determinant of the presence or absence of a unitary business when the asset in question is itself a business. Other assets, such as the short-term bank accounts and

125. Goodman, *supra* note 109, at 48.
126. Butler Bros. v. McColgan, 315 U.S. 501, 504 (1942).
127. F.W. Woolworth Co. v. Taxation and Revenue Dept. of State of N.M., 458 U.S. 354, 362 (1982).
128. ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 314 (1982).
129. Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768, 773–74 (1992).

hedges used as examples in *MeadWestvaco*, are tested under an operational analysis. In any case, they are two faces of the same unitary business principle.

C. The Aftermath of *MeadWestvaco*

Despite the similarities between the two tests, the holding that the three traditional factors must be applied in preference to the operational function test when an asset is a business has significant consequences for both states and taxpayers. This case note closes with a consideration of some of these consequences.

1. Changes in State Law

Recent commentary on *Allied-Signal* reveals that Illinois's position was at the very least a fair interpretation of the Court's precedent on the operational function analysis. James Peters and Benjamin Miller argued that the definition of "business income" under the Uniform Distribution of Income for Tax Purposes Act (UDITPA) should be "a unitary test that is similar to the Supreme Court's operational function test . . . in *Allied-Signal.*"[130] Similarly, the operational function test was mentioned by one commentator as the reason why Ohio should broaden its definition of taxable business income to the constitutional limit of apportionable income, thereby permitting Ohio to tax allegedly non-business income exempted under Ohio's then-current definition.[131] An expanded discussion of both this constitutionally-based income definition and UDITPA as they relate to flow-through entities and joint ventures mentions the operational function test as one of the two tests possible under the unitary business principle, with the other being the unitary relationship test.[132]

This "two test" understanding of the unitary business principle is essentially the same as that applied by the Illinois First District Court of Appeals and overruled by the United States Supreme Court in

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130. Peters & Miller, *supra* note 10, at 59.

131. April L. Butler, Comment, *A Look at What the Cat Dragged In: The Problems Inherent in Ohio's Commercial Activity Tax*, 32 U. DAYTON L. REV. 99, 143 (2006). Note that Illinois has adopted the proposed change in its own statutory definition of business income. MeadWestvaco Corp. v. Ill. Dept. of Revenue, 553 U.S. 16, 21 n.2 (2008).

132. Scott D. Smith, *State Income Tax Treatment of Dispositions of Interests in Flow-Through Entities and Joint Ventures*, *in* TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2007, 791 (West 2007).

MeadWestvaco.[133] Illinois was not the only state which recognized the existence of the operational function test as a separate ground of apportionment. New Jersey enacted a statute explicitly incorporating the operational function test, with legislative history suggesting the *Allied-Signal* holding as a major motivating factor for the state's actions.[134] As Jordan Goodman notes, *MeadWestvaco* will have an effect on states like Illinois which define taxable business income as extending to the limits the Constitution allows.[135] Such states will be required to apply the three traditional factors of functional integration, centralization of management, and economies of scale to asset businesses. A unitary relationship is a prerequisite even when such assets are intangibles (such as shares of ownership). Furthermore, states are precluded from applying the operational function test to "get in the back door" and therefore may not tax asset businesses that do not have unitary relationships with the taxpayer. Goodman observes that taxpayers who have stakes in asset businesses now need only worry about avoiding being classified as a unitary business.[136] This element of the Court's holding can be considered a victory for nondomiciliary corporate taxpayers for reasons that will be discussed below. One final immediate effect of the ruling is to lay ground for a challenge to the New Jersey act mentioned above.

2. Impact on Tax Planning

One potential response which corporate taxpayers may have to the *MeadWestvaco* holding is to take advantage of the Court's requirement that an asset business have a unitary relationship with its taxpayer parent. A corporation such as Mead could establish a subsidiary business such as Lexis, then maintain as little relationship as possible between itself and its subsidiary. In this manner, the parent corporation may be able to avoid satisfying the three traditional factors which the Court applies to determine if there is a unitary relationship between the parent and the subsidiary. So long as a sufficient distance is kept between parent and subsidiary, the parent can avoid apportionment. This could prove to be a great tax advantage if the parent's principal place of business has a low business tax rate. The parent reaps the

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133. Mead Corp. v. Dept. of Revenue, 861 N.E.2d 1131 (Ill. App. Ct. 2007), *overruled by* MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16 (2008).

134. *See* McKesson Water Products Co. v. Dir., Div. of Taxation, 23 N.J. Tax 449, 453–54 (N.J. Tax Ct. 2007). (New Jersey income tax statute enacted which included operational function test, legislative history provides evidence that *Allied-Signal* was a motivation).

135. Goodman, *supra* note 109, at 48.

136. *Id.*

benefits of its relationship with its subsidiary without being subject to the tax consequences of a unitary relationship.

While corporate taxpayers may reap tax benefits from this arrangement, states are simultaneously deprived of tax revenue which arguably should fairly belong to them. Extraterritorial subsidiaries, even if not closely related to their parents, are beneficiaries of investments from the parent both at the establishment or purchase of the subsidiary and potentially throughout the entire life of the business. Such a flow of value is exactly the kind of benefit that the unitary business principle was designed to permit states to tax.[137] Depriving states of the ability to tax such benefits is unfair to the states and counterproductive to the purposes of the principle the Court so adamantly defends in *MeadWestvaco*. While the Court's analysis in this case correctly interprets the unitary business principle, the unintended consequences of that analysis make *MeadWestvaco* a double edged sword.

A possible solution to this problem was presented by the Multistate Tax Commission ("MTC"), *amicus* in *MeadWestvaco*: permit states to tax the income of intangibles on the basis of connections between the asset and the taxing state.[138] In the disputed assessment that led to *MeadWestvaco*, IDOR had attempted to tax Mead Corp. on the income received from the sale of Lexis's goodwill.[139] Goodwill had been held in *Adams Express Co. v. Ohio State Auditor* to be located for tax purposes at the place where the business in question conducts its operations.[140] This rule has been applied in the income tax context in several cases and, accordingly, the income from the sale of Lexis's goodwill was properly taxable by Illinois as the ongoing business that the goodwill represented conducted activities in multiple states and could not be confined to Mead's domicile of Ohio.[141] The reason this connection is important, MTC argues, is that it forms a direct link between the source of income (Lexis) and the taxing state (Illinois) which makes use of the unitary business principle unnecessary.[142]

MTC asserts that all modern unitary business cases have dealt with situations in which the value being taxed was extraterritorial, a situation from which this case is distinct.[143] MTC argues that because in this case taxation of

137. *See* Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 220–21 (1897).
138. MeadWestvaco Corp. v. Ill. Dept. of Revenue, 553 U.S. 16, 30 (2008).
139. Brief of Multistate Tax Commission as Amicus Curiae in Support of Respondents at 19–21, *MeadWestvaco*, 553 U.S. 16 (No. 06-1413), 2007 WL 4351585.
140. *Adams Express Co.*, 166 U.S. at 223–24.
141. Brief of Multistate Tax Commission as Amicus Curiae in Support of Respondents, *supra* note 139 at 21–22.
142. *Id.* at 26.
143. *Id.* at 24, 26.

the Lexis sale "may be sustained independently of any unitary or functional connection between Lexis/Nexis and Mead Paper, the proper focus of . . . inquiry should be whether Illinois's tax has impermissibly burdened interstate commerce."[144] MTC asserts that the proper test of whether interstate commerce is impermissibly burdened is contained in *Complete Auto Transit, Inc. v. Brady*.[145] That case provides a four-part test in which a tax is permissible: where there is a substantial nexus between the activity taxed and the taxing state, where the tax is apportioned fairly among the states, where the tax "does not discriminate against interstate commerce," and where the tax fairly relates to the services the taxing state provides.[146] Just because a capital gain is at issue, MTC concludes, does not mean that the state loses the ability to tax a nondomiciliary on income generated within the state.[147]

As noted above, the Supreme Court declined to address this potential ground for taxation as the issue was not raised before the lower courts and the states which tax under this rule (Ohio and New York) were not represented before the Court.[148] The Court may have the opportunity to do so in the near future if, as Jordan Goodman predicts, IDOR relies upon this argument as its litigation against MeadWestvaco continues.[149] If IDOR does assert its ability to tax MeadWestvaco directly on the gain from sale of goodwill sited in Illinois, the two parties will likely argue over the case which serves as the ground for MTC's argument, *Whitney v. Graves*.[150] The Supreme Court there upheld an income tax by New York of a nonresident on a capital gain derived from the sale of a seat on the New York Stock Exchange.[151] IDOR could be expected to argue, as MTC did in its brief, that there is no reason to draw a distinction between income from earnings and income from capital gains.[152] At first blush it would appear that IDOR would succeed at this argument. Income earned in a state by a nondomiciliary as a result of a direct sale of assets, such as that derived here, should logically be treated the same as that taxed in *Whitney*. However, only time will tell how the Court will ultimately decide when the issue is before it.

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144. *Id.* at 26–27.
145. *Id.* at 27.
146. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).
147. Brief of Multistate Tax Commission as Amicus Curiae in Support of Respondents, *supra* note 139 at 28.
148. *MeadWestvaco*, 553 U.S. at 29-31.
149. Goodman, *supra* note 109, at 48.
150. *See* Brief of Multistate Tax Commission as Amicus Curiae in Support of Respondents, *supra* note 139 at 22.
151. Whitney v. Graves, 299 U.S. 366 (1937).
152. Brief of Multistate Tax Commission as Amicus Curiae in Support of Respondents, *supra* note 139 at 28.

V. CONCLUSION

The Supreme Court's decision in *MeadWestvaco* is yet another attempt to clarify and refine the longstanding unitary business principle. It makes clear that the principle is not simply a collection of formulaic tests but rather consists of a broad yet basic concept: to tax a nondomiciliary on an in-state asset, the state must show a sufficient relationship between the in-state asset and the nondomiciliary's business. The overall goal of fairness to taxpayer and state alike is served when the doctrine is satisfied, and it remains broad enough to encompass the many possible situations where nondomiciliaries may be subject to tax. *MeadWestvaco* is truly a triumph of substance over form. Fairness also motivates what may be the next major test of the principle: the question of whether states may tax income earned by a nondomiciliary's in-state assets when they are directly linked with the taxing state. It remains to be seen whether the Court will remain true to the goals of the unitary business principle by permitting states to tax such income without turning to the principle at all. The Court's past flexibility in applying this necessary doctrine suggests that it may indeed be willing to make this step. It would be a shame for the Court to allow a sizeable loophole to develop in an otherwise carefully stewarded doctrine.