

Apportionment Issues

By Michael S. Schadewald

U.S. Supreme Court Limits Scope of Operational Function Test

On April 15, 2008, the U.S. Supreme Court handed down its ruling in *MeadWestvaco Corp. v. Illinois Dep't of Revenue*.¹ The issue in this case is whether the State of Illinois is constitutionally prohibited from taxing an apportioned share of the \$1 billion gain realized by Mead Corporation in 1994 when it sold its investment in Lexis/Nexis. MeadWestvaco is the successor in interest to Mead, which was an Ohio corporation. Lexis/Nexis (Lexis) was one of Mead's business divisions. The Illinois Trial Court ruled that although Mead and Lexis were not engaged in a unitary business, the gain qualified as apportionable income under the Illinois statutory definition of business income.² The Illinois Appeals Court affirmed the trial court's decision, finding that Lexis served an operational function in Mead's business.³ The Illinois Supreme Court denied a petition for appeal,⁴ but the U.S. Supreme Court granted Mead's petition for *certiorari*.

The Supreme Court vacated the Illinois Appeals Court decision on the grounds that it misinterpreted the Court's references to "operational function" in *Allied-Signal, Inc. v. Director, Division of Taxation*⁵ as modifying the unitary business principle to add a new basis for apportionment. The Court explained that the operational function concept described in *Allied-Signal* merely recognizes the reality that an asset can be part of a taxpayer's unitary business even if there is no unitary relationship between the payee (taxpayer) and payer (asset). In addition, because the Illinois Appeals Court did not rule on whether Mead and Lexis formed a unitary business, the Illinois Appeals Court may take up that issue on remand.



Michael S. Schadewald, Ph.D., CPA, is a Professor in the School of Business Administration at the University of Wisconsin-Milwaukee.

Unitary Business Principle

The U.S. Constitution prohibits a state from taxing an out-of-state corporation on income derived from

an unrelated activity that has nothing to do with the business activity of the taxpayer in the taxing state. This principle reflects the fundamental requirement of the Due Process and Commerce Clauses that there be “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”⁶ Under the unitary business principle, if a corporation’s interstate activities form a unitary business, a state need not isolate the corporation’s in-state activities from the rest of the business in determining the corporation’s taxable income. Instead, the state may tax an apportioned percentage of the income generated by the multi-state unitary business. As a consequence, in the state income tax field, “the linchpin of apportionability ... is the unitary business principle.”⁷

The unitary business principle was developed late in the 19th century to address the challenges that arose when states attempted to impose property taxes on interstate railroad and telegraph companies. For example, to fairly determine the value of an interstate railroad’s track located within a state, it was necessary to apportion a share of the value of the entire multistate business rather than attempt to isolate the value of the in-state property.

The term “nonbusiness income” is often used to refer to an item of income derived by a corporation from an activity that has nothing to do with the taxpayer’s business activity in the taxing state. Under the Uniform Division of Income for Tax Purposes Act (UDITPA), nonbusiness income means any income other than business income, which UDITPA defines as “income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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.”⁸ Thus, under UDITPA, an item of income is classified as apportionable business income if it either arises from a transaction in the regular course of the taxpayer’s

business (transactional test), or from property that is an integral part of the taxpayer’s business (functional test).⁹

***Allied-Signal* (1992) and the Operational Function Test**

Prior to *MeadWestvaco*, the most recent Supreme Court decision regarding nonbusiness income was *Allied-Signal*.¹⁰ In *Allied-Signal*, the taxpayer was Bendix Corporation (*Allied-Signal* was the successor in interest to Bendix), a Delaware corporation that was commercially domiciled in Michigan and conducted business in all 50 states. In 1981, Bendix realized a \$211.5 million gain from the sale of 20.6 percent of the stock of ASARCO, Inc. The Supreme Court ruled that the State of New Jersey was constitutionally prohibited from including the gain in the taxpayer’s apportionable business income because none

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of the factors that would indicate that Bendix and ASARCO were engaged in a unitary business (*i.e.*, functional integration, centralized management or economies of scale) were present. As a result, the Court concluded that Bendix and ASARCO were “unrelated business enterprises each of whose activities had nothing to do with the other.” In addition, the ownership of ASARCO stock did not serve an operational function in Bendix’s business—“the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one.”

In arriving at its decision in *Allied-Signal*, the Supreme Court stated that “the payee and the payer 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.” As an example of an asset that serves an operational function, the Court mentions “interest earned on short-term deposits ... if that income

forms part of the working capital of the corporation's unitary business." The Court's reference to an operational function in this case was widely interpreted as creating a new test for apportionable business income. Under the alleged operational function test, even if no unitary business exists between the payee (taxpayer) and payer (asset), a state may still tax an apportioned percentage of the income from an intangible asset if that asset serves an operational function rather than an investment function in the taxpayer's business.

The MeadWestvaco Case

Mead Corporation (MeadWestvaco is the successor in interest to Mead) was an Ohio corporation. In 1968, Mead purchased Data Corporation for \$6 million. At that time, Mead was a producer and seller of paper, packaging and school and office supplies, whereas Data was starting to develop a computerized full text information retrieval system. By 1973, Data had evolved into Lexis. Over the years, Mead made numerous capital contributions to Lexis, which became profitable at the end of the 1970s. During its ownership of Lexis, Mead structured Lexis as both a corporate division and as a subsidiary. At the time of its sale in 1994, Lexis was a division of Mead.

Although Lexis was subject to Mead's oversight, Mead did not manage the day-to-day affairs of Lexis. Mead was headquartered in Ohio, while a separate management team ran Lexis out of its headquarters in Illinois. The two businesses maintained separate manufacturing, sales and distribution facilities, as well as separate accounting, legal, human resources, credit and collections, purchasing and marketing departments. They did not share personnel, and neither was required to purchase goods or services from the other. Mead's involvement in Lexis was generally limited to approving Lexis' annual business plan and any significant corporate transactions (such as major capital expenditures, financings, mergers and acquisitions or joint ventures) that Lexis wished to undertake. Mead did, however, make daily cash sweeps of Lexis' bank accounts, and invested the funds for the benefit of Lexis. Mead also reported in its annual reports and SEC filings that it was engaged in electronic publishing and that Lexis was one of its business segments.

Since 1988, the Illinois Department of Revenue had asserted that Mead and Lexis were a unitary business.

Although Mead disagreed, to settle disputed audit findings, Mead included Lexis in its unitary business group from 1988 through 1994. In May 1994, Mead announced its plan to sell Lexis (which was structured as a division), stating in its press release that it had "grown" Lexis "since 1968 from a small legal database into the world's premier provider of online legal information and the pioneer in computer-assisted news retrieval." In December 1994, Mead sold the assets of the Lexis division at a gain of roughly \$1 billion, and used the proceeds to pay the federal taxes on the gain, repurchase some of its stock and pay off some of its debts. On its 1994 Illinois tax return, Mead classified the \$1 billion gain as nonbusiness income that should be allocated to Mead's state of commercial domicile, which was Ohio. After an audit, the Illinois Department of Revenue reclassified the gain as apportionable business income.

State Court Rulings in MeadWestvaco

The Illinois Trial Court concluded that Mead and Lexis were not engaged in a unitary business because there was no functional integration, centralized management or economies of scale. Nevertheless, under the Illinois statutory definition of business income (which conformed to UDITPA), the gain qualified as business income under the functional test because the property disposed of in the liquidation was "essential" to the taxpayer's regular trade or business. Moreover, Mead's investment in Lexis served an "operational purpose" in that Lexis represented a significant business segment of Mead. In summary, the Illinois Trial Court concluded that Mead's \$1 billion gain was properly classified as apportionable business income.¹¹

The Illinois Appeals Court affirmed the trial court's decision. In its appeal, Mead argued that the \$1 billion gain was not includible in apportionable business income because Mead and Lexis were not engaged in a unitary business, and because Mead's ownership of Lexis did not serve an operational function in its business. The appeals court disagreed, citing several factors as evidence that Lexis served an operational function in Mead's business: (1) Mead owned 100 percent of Lexis, (2) Mead exercised its control over Lexis in various ways, such as approving major capital expenditures, manipulating its corporate form (division versus subsidiary) for Mead's benefit and retaining

tax benefits and control over Lexis' excess cash, and (3) Mead reported in its annual reports and SEC filings that it was engaged in electronic publishing and that Lexis was one of Mead's business segments. The appeals court did not address the issue of whether Mead and Lexis were engaged in a unitary business.¹²

The Illinois Supreme Court denied review,¹³ but the U.S. Supreme Court granted Mead's petition for *certiorari*.¹⁴

U.S. Supreme Court Ruling

The U.S. Supreme Court vacated the decision of the Appellate Court of Illinois on the grounds that the state court misinterpreted the reference to "operational function" in *Allied-Signal* as modifying the unitary business principle to add a new basis for including a gain in apportionable business income.¹⁵ The Supreme Court also indicated that because the Illinois Appeals Court has yet to rule on whether Mead and Lexis formed a unitary business, it could take up that issue on remand.

The Court explained that its reference to "operational function" in *Allied-Signal* was "not intended to modify the unitary business principle by adding a new ground for apportionment." Instead, the operational function concept merely recognizes the reality that an asset can be part of a taxpayer's unitary business even if there is no unitary rela-

tionship between the payee (taxpayer) and payer (asset). Thus, whether an asset serves an operational function in the taxpayer's business is "merely instrumental to the constitutionally relevant conclusion that the asset was a unitary part of the business being conducted in the taxing State."¹⁶

The Court illustrated this point using examples drawn from its earlier decisions. In *Allied-Signal*, the Supreme Court stated that apportionable business income includes "interest earned on short-term deposits in a bank located in another State if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." The taxpayer is not unitary with the payer of the income (the bank), but the taxpayer's deposits (working capital and thus operational assets) are clearly unitary with the taxpayer's business. Likewise, in *Container Corp. of America v. Franchise Tax Board*,¹⁷ the Supreme Court stated that "capital transactions can serve either an investment function or an operational function," and noted that it had made this distinction in another context in *Corn Products Refining Co.*¹⁸ In *Corn Products*, a manufacturer purchased commodity futures to secure supplies of raw materials at an economical price. Thus, the taxpayer was not unitary with the payer of the income (the counterparty to the futures contracts), but the taxpayer's futures contracts (hedges against the risk of a price increase for raw materials) were clearly unitary with the taxpayer's business.

ENDNOTES

- ¹ *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, SCt, Dkt. 06-1413, 553 US ___ (Apr. 15, 2008).
- ² *Mead Corp. v. Dep't of Revenue*, No. 00 CH 7854 (Ill. Cir. Ct. Cook Cty. Mar. 18, 2003).
- ³ *Mead Corp. v. Dep't of Revenue*, 371 Ill. App. 3d 108, 861 NE 2d 1131 (Ill. App. Ct. 1st Dist. 6th Div. Jan. 12, 2007).
- ⁴ *Mead Corp. v. Illinois Dep't of Revenue*, 222 Ill. 2d 609, 862 NE2d 235 (Ill. 2007).
- ⁵ *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 US 768, 1112 SCt 2251 (1992).
- ⁶ *Miller Bros. Co. v. Maryland*, 347 US 340, 74 SCt 535 (1954).
- ⁷ *Mobil Oil Corp. v. Comm'r of Taxes*, 445 US 425, 100 SCt 1223 (1980).
- ⁸ UDITPA §1.
- ⁹ MTC Reg. IV.1(a).
- ¹⁰ *Supra* note 5.
- ¹¹ *Supra* note 2.
- ¹² *Supra* note 3.
- ¹³ *Supra* note 4.
- ¹⁴ *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, *cert. granted*, 128 SCt 29, 168 L. Ed. 2d 806 (Sept. 25, 2007).
- ¹⁵ *Supra* note 1.
- ¹⁶ *Id.*
- ¹⁷ *Container Corporation of America v. Franchise Tax Board*, 463 US 159, 103 SCt 2933 (1983).
- ¹⁸ *Corn Products Refining Co.*, SCt 55-2 *ustc* ¶9746, 350 US 46, 76 SCt 20.

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