No. 06-1413

IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION,
SUCCESSOR IN INTEREST TO THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE,
DIRECTOR OF THE ILLINOIS DEPARTMENT OF
REVENUE, AND TREASURER OF THE
STATE OF ILLINOIS,
Respondents.

ON WRIT OF CERTIORARI TO THE
APPELLATE COURT OF ILLINOIS

BRIEF FOR THE WALT DISNEY COMPANY AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether a state may, consistent with the Commerce Clause and Due Process Clause, tax a non-domiciliary corporation on the gain from its sale of stock in another non-domiciliary corporation that it held for investment purposes on the ground that the parent's investment in, oversight of, and sale of the subsidiary served an "operational function."

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INTEREST OF AMICUS CURIAE

The Walt Disney Company is a diversified entertainment company and the parent corporation of a group of affiliated companies with operations through-

out the United States and around the world.[1] In the course of its business, Disney has often acquired substantial shares of other companies and held them for investment purposes. Disney is a publicly traded company and is required to file various public documents with the Securities and Exchange Commission. In compliance with SEC reporting requirements, Disney employs a consolidated reporting regime to reflect Disney's overall financial performance for each reporting period, including the performance of its investment holdings. Like petitioner, Disney utilizes a cash management system to maximize the earning potential of its cash holdings and those of its subsidiaries for the benefit of its shareholders. Also like petitioner, Disney is currently involved in litigation with the Illinois Department of Revenue concerning whether proceeds from the sale of shares in a business held for investment purposes constitute apportionable income.

SUMMARY OF ARGUMENT

I. A state may not tax revenue earned by an out-of-state corporation unless that value is fairly attributable, at least in part, to in-state activity. This Court has developed the unitary business principle to detect instances where states overreach by attempting to tax revenue that they are not entitled to share. That principle reflects and enforces the due process and com-

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[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amicus curiae or its counsel made a monetary contribution to its preparation or submission.

merce clause concerns that underlie the limitations on state taxation.

In *Allied-Signal, Inc.* v. *Director, Division of Taxation*, 504 U.S. 768 (1992), this Court recognized that, in addition to the revenue generated by a corporation in the course of its unitary business, states possess the power to tax revenue generated through a capital transaction that serves an operational function. The operational function test was not intended to erode the important limits of the unitary business principle, rather, it was only intended as a narrow supplement to that principle.

The Appellate Court of Illinois, however, has mistakenly read the operational function test as a radical expansion of state taxation power. That misinterpretation led it to uphold an exaction on revenue that petitioner earned outside Illinois, that had no rational nexus to Illinois, and to which Illinois had contributed no value. This reading of the operational function test, if adopted, will free states to impose arbitrary and unreasonable taxes on multi-state businesses.

II. The Appellate Court of Illinois mistook numerous factors as indicative of operational control of a subsidiary when those factors are wholly consistent with the subsidiary being held only for investment purposes. The practical implication of allowing those factors to be incorporated into the apportionment analysis is to penalize companies that act in full compliance with accounting and reporting requirements and engage in responsible oversight of their investments.

III. As a side-effect of beneficial mergers and acquisitions, companies frequently come to control subsidiaries that provide no economic value to their other holdings. The analysis employed by the Appellate

Court of Illinois will sometimes raise transaction costs for such acquisitions.

IV. If the operational function test is allowed to substantially erode the limits of the unitary business principle, companies will be penalized for having structured transactions to conform to *Allied-Signal*. It will also raise the substantial specter of double taxation.

ARGUMENT

I. THE COURT BELOW FUNDAMENTALLY MISAPPREHENDED AND MISAPPLIED THE OPERATIONAL FUNCTION TEST ARTICULATED IN *ALLIED-SIGNAL*

The Constitution generally prohibits states from taxing non-domiciliary corporations on revenues earned outside the taxing state. Two rules provide important, but limited, exceptions to this general prohibition. One, the "unitary business" principle, articulates the primary basis on which states may reach the out-of-state revenues of out-of-state corporations and has been termed the "linchpin" of the analysis as to whether such taxation is permissible. *See Mobil Oil Corp.* v. *Vermont Comm'r of Taxes*, 445 U.S. 425, 439 (1980). The unitary business principle is supplemented by the "operational function" test, which allows states to go beyond the unitary business principle to reach a narrow class of capital transactions occurring outside their borders. *See Allied-Signal, Inc.* v. *Director, Div. of Taxation*, 504 U.S. 768, 787 (1992).

In the proceedings below, the court permitted Illinois to tax revenue generated by petitioner Mead Corporation, which is incorporated in Ohio, through the sale of Lexis/Nexis, an entity unrelated to Mead's business activities in Illinois. The court expressly disclaimed any reliance on the unitary business principle,

concluding that the tax was defensible strictly based on the operational function test. In doing so, the court stretched the meaning of operational function beyond all reasonable bounds.

A. The Unitary-Business Principle Is, For Good Reasons, The Principal Test For Assessing Whether A State May Tax An Out-of-State Corporation's Revenues Earned Out Of State

"[A] State may not tax value earned outside its borders." *Allied-Signal*, 504 U.S. at 777. This principle finds support in two constitutional provisions. The dormant Commerce Clause prohibits extraterritorial taxation because of the burden on interstate commerce that would result if states were permitted to tax activity occurring in other states. *See Mobil Oil*, 445 U.S. at 443. In addition, the Due Process Clause prohibits such taxation because it would be arbitrary and unfair for a state to tax activity without "some minimal connection between those activities and the taxing state" and unless "the income attributed to the State for tax purposes [is] rationally related to 'values connected with the taxing State.'" *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273 (1978) (quoting *Norfolk & W. Ry. Co.* v. *Missouri State Tax Comm'n*, 390 U.S. 317, 325 (1968)).

These constitutional principles have particular importance where, as in this case, a state attempts to tax revenues earned by an out-of-state corporation. As this Court has made clear, when a state imposes taxes on non-domiciliary corporations, it does so not out of sovereign right, but only as a fair "price for the privileges it afforded foreign corporations within its borders." *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 442 (1940). Where a state attempts to tax an out-of-state corporation on activities that take place entirely outside the

state's borders, there is a danger that exaction will be more in the "nature of an extortion than a tax." *Union Refrigerator Transit Co.* v. *Kentucky*, 199 U.S. 194, 202 (1905).

This Court has also recognized, however, that when a business operates in multiple jurisdictions, the whole is often worth more than the sum of the constituent parts. *See Ford Motor Co.* v. *Beauchamp*, 308 U.S. 331, 337 (1939). As a result, unless states are allowed to look to the value of the corporation in its entirety, they are likely to undervalue their fair share of corporate revenue. This will frustrate their legitimate interest in revenue collection. Therefore, under appropriate circumstances, states may engage in "apportionment"; that is, they may tax a proportional share of a multi-state corporation's entire revenue, even that earned out of state.

Yet not all revenue produced by multi-state corporations can fairly be treated as apportionable. After all, the "only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it." *Norfolk & W. Ry.*, 390 U.S. at 325 n.6 (quoting *Wallace* v. *Hines*, 253 U.S. 66, 69 (1920)). This is only true when in-state properties are "part of an organic system of wide extent, that gives them a value above what they otherwise would possess." *Id.*

As this case demonstrates, there are often occasions when a multi-state corporation will come to own an interest—sometimes even a controlling interest—in a business operating in an industry wholly unrelated to its own. Often, these holdings are not part of the corporation's "organic system"; they are distinct from the operations of their owner and they do not make the

constituent parts of the owner's business any more valuable. Under such circumstances, there is no justification for extraterritorial taxation.

This Court developed the "unitary business" principle to identify those circumstances in which it is reasonable for states to tax an apportioned share of corporate revenue. *See ASARCO, Inc.* v. *Idaho State Tax Comm'n*, 458 U.S. 307, 320 n.14 (1982) (collecting cases detailing the evolution of the unitary business principle). Under the unitary business rule, states may apportion all of a multi-state business's revenue that is generated in the conduct of its unitary business, but are not entitled to a share of the proceeds from "unrelated" business activity. *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M.*, 458 U.S. 354, 362 (1982). The Court has further clarified that three factors are "the hallmarks" of a unitary business: functional integration, centralization of management, and economies of scale between the entities that compose the business organization. *Allied-Signal*, 504 U.S. at 789.

These three factors demonstrate that the constituent entities of the unitary business are not merely related, but also create value for one another. In the presence of these factors, courts can reliably conclude that the in-state property possesses "enhanced value" stemming from its relationship with a larger system, *Pullman Co.* v. *Richardson*, 261 U.S. 330, 338 (1923), and that due process will not be offended by having the state apportion a share of the corporation's entire revenue. Thus, the unitary business principle employs metrics specifically tailored to the due process concerns regarding extraterritorial taxation.

B. *Allied-Signal*'s Discussion Of Operational Functions Was Designed To Provide Only A Narrow Supplement To The Unitary Business Rule

Given that the unitary business principle largely addresses the due process and commerce clause concerns underlying the restrictions on the apportionment of out-of-state income, it should come as no surprise that it has been the dominant mechanism for determining whether income may be apportioned. This Court has repeatedly called the unitary business principle the "linchpin of apportionability." *See F.W. Woolworth*, 458 U.S. at 362 (quoting *ASARCO*, 458 U.S. at 319 (quoting *Exxon Corp.* v. *Wisconsin Dep't of Revenue*, 447 U.S. 207, 223 (1980) (quoting *Mobil Oil*, 445 U.S. at 439))). It has also stated that "'[f]ormulary apportionment, which takes into account the entire business income of a multistate business in determining the income taxable by a particular state, is constitutionally permissible *only* in the case of a unitary business.'" *ASARCO*, 458 U.S. at 320 n.14 (quoting Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 Tax L. Rev. 171, 183-184 (1970) (alteration in original) (emphasis added)). In *Allied-Signal*, the Court's most recent case on the subject, New Jersey urged the Court to abandon the unitary business principle, and the Court emphatically declined the invitation and reaffirmed the principle's primacy in the due process and commerce clause analyses. 504 U.S. at 785.

Despite the Court's heavy reliance on the unitary business principle, the concept does not quite reach the entire universe of situations where revenue generated out of state may be apportionable. That is because the unitary business principle, and the three factors it con-

siders, are only suited to assess whether different sets of *business activities* are sufficiently related to be considered unitary. The rule is not readily adaptable to capital transactions, particularly those undertaken with unrelated parties such as banks.

The issue of capital transactions was discussed in *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159 (1983). The Court noted that "capital transactions can serve either an investment function or an operational function." *Id.* at 180 n.19. It drew this principle from a case holding in a different context that when a business purchases futures or options as a hedge against changes in market conditions within its field of business, those futures serve an operational rather than an investment function. *See id.* (citing *Corn Prods. Refining Co.* v. *Commissioner*, 350 U.S. 46, 50-53 (1955)). Although the Court stated that revenue generated through operational functions is apportionable, while investment income is not, it provided little further clarification.

The *Allied-Signal* Court expanded on the discussion in *Container Corp.*, and articulated the relationship between operational functions and the unitary business principle. The Court stated 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." 504 U.S. at 787. An operational function analysis "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785.

Although the Court did not provide any further definition of an operational function, it gave an example

of a capital transaction that would qualify. Specifically, revenue produced through "short-term investment of working capital analogous to a bank account or certificate of deposit" is apportionable on that rationale. 504 U.S. at 790.

The Court also noted two factors it deemed irrelevant to whether a capital transaction is operational. First, "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." 504 U.S. at 788. Second, the intended (or even actual) future use of the proceeds, *i.e.*, the gain from the sale of an investment asset, cannot be used to convert what would be non-apportionable income into apportionable income. *See id.* at 789.

Although the Court did not define the full scope of the operational function text in *Allied-Signal*, it gave no indication that it was recognizing a broad new category of apportionable revenue or that it was retreating from the understanding that the unitary business principle is the "linchpin" of the apportionability analysis. Therefore, it seems safe to draw three conclusions regarding the "operational function" category.

First, it applies only to capital transactions; the Court gave no indication that *business activity* should not continue to be assessed exclusively under the unitary business principle.

Second, the example selected by the Court suggests that the theory underlying the operational function category is that some capital transactions may be so intimately tied to the business of a corporation that those transactions are part of the value of that business, even though in some respects they appear to be

mere investment activity. For example, holding operating capital in a bank is activity frequently undertaken as part of the day-to-day operation of a business. Consequently, any revenue that activity produce can fairly be classified as revenue of that business and apportioned, even if the revenue was not generated through sales or other traditional sources of business revenue.

Finally, the proper analysis turns on whether a capital transaction, such as investment in or sale of a subsidiary, served an operational function in *the owner's* business—not in the business of the subsidiary. Therefore, the fact that a subsidiary receives some value from oversight from the parent does not make the relationship operational. *See Container Corp.*, 463 U.S. at 180 n.19 (citing *F.W. Woolworth*, 458 U.S. at 369). However, a series of loans from the parent to the subsidiary may serve an operational function if they were undertaken to improve the *parent's* profitability. *See id.* Thus, the relevant inquiry is whether "the function of the investment is to make better use … of the *parent's* existing business-related resources." *Id.* at 178 (emphasis added). Bank accounts and hedging investments may meet these criteria; oversight of an investment in an unrelated business will not.

C. The Court Below Misconstrued The Breadth Of The Operational Function Category And Treated It More Expansively Than This Court Intended

In the decision below, the Appellate Court of Illinois latched on to the "operational function" language from *Allied-Signal* and upheld Illinois's attempt to tax petitioner on the sale of an investment held in Ohio, wholly unrelated to the petitioner's business activities in Illinois. *See* Pet. App. 1a-22a. That court failed to

read *Allied-Signal* for what it is: a strong reaffirmation of the right against arbitrary apportionment. Instead, it focused on the narrow clarification regarding the treatment of capital transactions and deduced from it an exception sufficient to swallow the rule.

This decision to employ an operational function rather than a unitary business analysis was crucial to the outcome below. It allowed the court to ignore factual findings by the trial court that Mead and Lexis/Nexis were not functionally integrated, did not have centralized management, and did not enjoy economies of scale. Under Illinois law, these factual findings were entitled to substantial deference and could be reversed only if they were contrary to the manifest weight of the evidence. *See* Pet. App. 7a. These three findings, taken together, are more than sufficient to preclude a finding that Mead and Lexis/Nexis were a unitary business because functional integration, centralization of management, and economies of scale are the "hallmarks of an acquisition that is part of the taxpayer's unitary business." *Allied-Signal*, 504 U.S. at 789.

Moreover, while the Appellate Court of Illinois insisted that it was employing an operational function analysis, the specific factors it considered bear no logical relationship to that test (as opposed to a unitary business analysis). The court did not examine, for example, whether Mead invested in Lexis/Nexis to facilitate its business activities (the production and sale of forestry products). It did not look to whether the money infused into Lexis/Nexis represented a short-term investment of working capital (which it clearly did not). It likewise did not attempt to determine whether Mead's ownership of Lexis/Nexis constituted a hedge against a change in market conditions in the forestry

products industry. Thus, although the operational function analysis is supposed to turn on the asset's "relation to the taxpayer and its activities within the taxing State," *Allied-Signal*, 504 U.S. at 785, the court undertook no examination of Lexis/Nexis's relation to Mead's business activities in Illinois (namely, the production and sale of forestry products), or how Mead's ownership of Lexis/Nexis might have facilitated those business activities.[2]

In fact, the court did not treat Mead's investment in Lexis/Nexis as a capital transaction at all. Instead, it looked to the relationship between the two companies, particularly the degree to which Mead managed Lexis/Nexis—precisely the domain of the unitary business principle. Thus, the court emphasized that Mead was the 100% owner of Lexis/Nexis, contributed capital support, approved major expenditures, changed the placement of Lexis/Nexis within the overall Mead corporate family, obtained tax benefits, and exercised control over excess cash. Pet. App. 12a-13a. These factors might have been relevant to ascertaining whether Lexis/Nexis was part of Mead's unitary business, *cf. Allied-Signal*, 504 U.S. at 789, but they do not sensibly

[2] The trial court finessed this issue by making a finding that "Mead was involved in the electronic publishing business." Pet. App. 36a. Based on that finding, the trial court concluded that Mead's investment in Lexis/Nexis served the operational function of facilitating Mead's electronic publishing business. The problem with this approach is that it rests on a tautology: Mead's ownership of Lexis/Nexis facilitated its business of electronic publishing, which consisted entirely of owning and investing in Lexis/Nexis. If this reasoning were sufficient to satisfy the operational function test, there would be little, if anything, of substance left to that test or to the unitary business principle, which the operational function test supplements in a limited way.

speak to whether Mead's investment in Lexis/Nexis served an operational function.[3]

Ownership and control cannot be dispositive, or even particularly probative, in the operational function analysis. A capital transaction inherently concerns the disposition of an asset—that is to say, ownership and control are at issue in *every* capital transaction.[4] Thus, bank accounts funded with working capital and options bought to hedge against changes in market conditions are under the complete control of the corporation that owns them. So, too, however, are passively held shares of stock acquired strictly for investment purposes.

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[3] The court's method of analysis affected its citation of authorities as well; the precedents it relied on are unitary business precedents. For example, the court quoted *Allied-Signal* for the premise that a "company's 20.6% ownership of subsidiary's stock did not establish [an] *operational relationship*." Pet. App. 13a (citing *Allied-Signal*, 504 U.S. at 788) (emphasis added). Yet the cited discussion does not come from *Allied-Signal*'s description of the operational function category; rather, the statement reads in full that "because Bendix owned only 20.6% of ASARCO's stock, it did not have the potential to operate ASARCO as an integrated division of a single *unitary business*." *Allied-Signal*, 504 U.S. at 788 (emphasis added). The same is true of the only other authority the court cited in the course of analyzing the operational function question. It attributed to the *ASARCO* Court the conclusion that "bare majority ownership of subsidiary's stock [was] not enough to show [an] *operational relationship* in light of lack of ability to control [the] subsidiary." Pet. App. 13a (citing *ASARCO*, 458 U.S. at 321-322) (emphasis added). The Court's actual conclusion was that the two businesses being evaluated were "insufficiently connected to permit the two companies to be classified as a *unitary business*." *ASARCO*, 458 U.S. at 322 (emphasis added).

[4] For example, even the sale or purchase of a non-controlling interest in a corporation implies ownership or control of the capital asset, namely the shares of stock.

What distinguishes the former from the latter is not control, it is the *function they serve in facilitating the owner's business*. If assets facilitate the owner's business, the gain on their sale may well be apportionable; if they are held only for investment purposes, then the Constitution limits the states' ability to reach them for taxing purposes.

II. THE COURT BELOW RELIED ON FACTORS THAT ARE NOT PROBATIVE IN EITHER THE UNITARY BUSINESS OR OPERATIONAL FUNCTION ANALYSIS

The Appellate Court of Illinois not only fundamentally misapprehended the purpose of the operational-function test; in supposedly applying that test, it relied on factors that are not probative of whether a state should be allowed to tax the out-of-state activity of out-of-state corporations under either the operational function or the unitary business approach.

Although the constitutional test for apportionability is "quite fact sensitive," *Allied-Signal*, 504 U.S. at 785, that does not mean that all facts are probative of that question. As explained below, several factors emphasized by the court shed little light on the issue of apportionability, for they are as consistent with one corporation owning another for investment purposes as they are with a corporate parent exercising operational control over a subsidiary. Use of those factors only muddies the waters, and, if relied on in other cases, could dramatically expand the reach of state taxation.

A. Cash Management

The Appellate Court identified petitioner's cash management system as a factor favoring apportionability of the proceeds of petitioner's investment in Lexis/Nexis. The court stressed that petitioner made

nightly cash sweeps of Lexis/Nexis's bank accounts and noted that, although petitioner invested the funds for Lexis/Nexis's benefit, it did so in a manner decided by petitioner. Pet. App. 3a.

This court's reliance on cash management systems is ill-considered, for it fails to recognize the widespread and entirely appropriate role of cash sweeps. Daily cash sweeps from subsidiaries, including non-unitary subsidiaries, are common within any large business organization. Cash sweeps are typically performed for purposes of cash control. Usually, the subsidiary records an account receivable in the amount of the sweep and the parent corporation, which sweeps the cash, records an account payable in its books in the same amount to document the transaction. Similarly, any interest earned on the swept cash is recorded, and reported for tax purposes, as income of the entity to which the cash belongs, *i.e.*, the entity from which the cash was initially swept.

A cash management system within a business organization is essentially an administrative mechanism. It is designed to provide accountability and limit the dispersion of liquid assets. It also allows for a maximization of the return that may be produced through consolidated investing. It is standard operating practice in many large business organizations and is routinely used in connection with subsidiaries over which the parent does not exercise managerial control.

Therefore, the mere existence of a cash management system is not relevant to an apportionability determination. Even when a subsidiary's cash is swept by the parent, it is often held for the benefit of the subsidiary and is not a font of operating capital for the owner. In such circumstances, the subsidiary's cash

does not serve an operational function for the parent. Moreover, because a cash sweep can be performed for any cash-producing subsidiary, even one in a "discrete" line of business, *ASARCO*, 458 U.S. at 320, it does not establish the existence of a unitary business. Cash sweeps do not suggest that the subsidiary is somehow producing value for the parent such that a non-domiciliary state is entitled to a share of the subsidiary's revenue.

B. Consolidated Reporting

The court below also improperly considered petitioner's consolidated reporting regime as a relevant factor in determining whether petitioner's investment in Lexis/Nexis served an operational or an investment function. Pet. App. 3a-4a, 13a. Petitioner, like other business organizations, utilized consolidated reporting in its financial statements, annual reports and other documents that, as a public company, it is required to file with the Securities and Exchange Commission. Consolidated reporting is often required for financial reporting purposes that have nothing to do with any factors that might be relevant to an apportionability analysis. Reporting is intended to provide useful information to investors and regulators, who may not be particularly concerned with whether a subsidiary served an operational function of a corporate parent.

Reporting requirements are framed in terms that have no particular relationship to the operational-function test for apportionability. Standards issued by the Financial Accounting Standards Board mandate the "way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim

financial reports issued to shareholders." *Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information* 4 (*FAS 131*). *FAS 131* expansively defines "operating segment" as

> a component of an enterprise: (a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise), (b) Whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and (c) For which discrete financial information is available.

Id. at 7. None of these factors suggests that an "operating segment" must facilitate or even be related to the reporting corporation's line of business. The fact that a corporation owns another company that is engaged in an operating business does not mean that the business is used in the operation of the parent company, as opposed to being held for investment purposes. Accordingly, the petitioner's decision to report on all "operating segments," as defined under *FAS 131*, should not influence the proper tax treatment of the gain on its sale of its stock in Lexis/Nexis.

C. Oversight Of Major Expenditures

The court below also relied on petitioner's approval of major debt and major capital expenditures by Lexis/Nexis in concluding that petitioner's investment in Lexis/Nexis served an operational rather than an investment function. Pet. App. 13a. Reliance on this fac-

tor is also misplaced, for prudent investors frequently retain the right to approve or at least be consulted on major expenditures without becoming involved in the operation of the company in which they invest—much less making that company involved in their own operations, which is the inquiry to which the operational-function test is directed.

Responsible investors routinely monitor significant expenditures of the businesses they own. In fact, this Court has explicitly recognized that there is a "type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary." *F.W. Woolworth*, 458 U.S. at 369. Similarly, venture capitalists investing in companies often require advance notification of and the right to approve major items of expenditure, including extraordinary transactions such as the incurrence of major debt and major capital expenditures. The right to approve such transactions is a measure of prudent investment, not operational function or a unitary business. Thus, creditors of companies, such as banks, often restrict the activities of debtor companies and require consent for extraordinary transactions so as to protect their investment, but such restrictions obviously do not convert the creditor and debtor into a unitary business. To be sure, oversight of major expenditures can also be consistent with a unitary relationship. But that is only the case when the "management role that the parent does play is grounded in its own operational expertise and its overall operational strategy." *Container Corp.*, 463 U.S. at 180 n.19. Under such circumstances, the monitoring is in actuality a form of "uncompensated technical assistance." *Id.*

Thus, in that absence of other factors, supervision of an investment does not make the revenue generated

by that investment apportionable. What is properly considered is whether the parent participated in management by utilizing expertise borne from engaging in the same line of business. In the absence of that factor, companies should not be penalized for protecting their shareholders' assets by insuring that their subsidiaries spend responsibly.

D. Investment Of Capital

A final factor on which the court below placed undue reliance was petitioner's history of making capital contributions to Lexis/Nexis. Pet. App. 13a. Investors frequently make capital contributions to companies in which they are investing without thereby creating an operational or unitary relationship. For example, venture capitalists frequently agree to make continuing capital contributions to start-up companies, but in such situations, no one would suggest that the venture capital company and the investment vehicle became a unitary business or were even operationally related. More generally, investors have a significant interest in ensuring that the businesses in which they invest are successful. This is most true when there is only one investor in the business since that investor carries all of the risk and enjoys all the potential reward. If the influx of capital is necessary in the early years of an investment, or even later because of a change in economic conditions, the investor has an incentive to contribute the capital necessary to promote the success of the business and, ultimately, his investment. Such investments, however, ordinarily do not create a unitary or operational relationship.

This Court has in the past looked to whether the parent invested capital in determining whether a subsidiary was involved in a unitary business. *See, e.g.*,

Container Corp., 463 U.S. at 179 (noting that the parent lent funds and offered loan guarantees to the subsidiary); *F.W. Woolworth*, 458 U.S. at 366 (noting that "each subsidiary was responsible for obtaining its own financing from sources other than the parent"). The flow of capital thus can be pertinent, on occasion, to whether income produced by the subsidiary is apportionable. Nonetheless, it would make little sense to treat this factor as determinative or even particularly probative.[5] As noted above, prudent investing often requires following an initial investment with the introduction of further funding. In this case, for example, it appears that Mead contributed capital support until Lexis/Nexis became profitable. That course only shows, however, that Mead made a wise decision not to abandon an initially unprofitable investment; it does not establish that Lexis/Nexis supported Mead's core lines of business.

If a single large initial investment does not create a unitary relationship, it is difficult to see why two smaller investments made sequentially should be treated differently. There are no additional ties in the second scenario that justify state apportionment. In the absence of other factors, infusing additional capital into a subsidiary should not be deemed to create a sufficient link between the subsidiary and the parent to justify extraterritorial state taxation.

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[5] In fact, it appears that the Court has, on at least one occasion, found that a secondary investment in a corporation did not render that subsidiary's revenue apportionable. *See F.W. Woolworth*, 458 U.S. at 366 n.14.

III. THE APPELLATE COURT'S APPROACH WOULD BURDEN ECONOMICALLY BENEFICIAL MERGER AND ACQUISITION ACTIVITY

Merger and acquisition activity forms a significant component of the United States' economy. In 2006, the aggregate volume of these transactions was $1.56 trillion dollars. Berman, *Year-End Review of Markets & Finance 2006—Can M&A's 'Best of Times' Get Better? —Private Equity Fuels A Frenzy of Deals; Cash on Sidelines*, Wall St. J., Jan. 2, 2007, at R5. Mergers and acquisitions occur regularly in many industries. These combinations are often beneficial to both consumers and to the economy. "Merging parties may reduce their costs by combining complementary assets, eliminating duplicate activities, or achieving scale economies. Mergers also may lead to enhanced product quality or to increased innovation that results in lower costs and prices or in more rapid introduction of new products that benefit consumers." United States Department of Justice & Federal Trade Commission, *Commentary on the Horizontal Merger Guidelines* 49 (Mar. 2006), *available at* http://www.usdoj.gov/atr/public/guidelines/215247.pdf.

The approach taken by the Illinois court could well hamper such economically beneficial merger and acquisition activity. When one corporation acquires another, it must often agree to take control of assets or lines of business it does not find desirable or synergistic. "[A target] will often have assets that [a would-be purchaser] does not want to own, directly or indirectly, after the acquisition ('unwanted assets')." Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts: A Transactional Analysis of Governing Tax, Legal, and Accounting Considerations* ¶ 106.10, at 1-32 (Dec. 2003). Yet frequently, a target "may offer to sell itself only as

a 'complete' entity, either by selling all of its assets or by being the subject of a stock acquisition." Phillips & Rothman, 770-3rd Tax Mgmt. Portfolios, S*tructuring Corporate Acquisitions—Tax Aspects*, A-153 (2005). As a result, corporations can often come to own subsidiaries or divisions that do not enhance the value of their other holdings.

Under these circumstances, the acquirer will frequently take steps to dispose of the unwanted asset. However, for a variety of reasons, including market timing, an acquirer may find it prudent to hold the asset for a time until a more profitable opportunity to dispose of it arises. In the interim, the acquirer has little choice but to allow the unwanted unit to continue to operate as a going concern. In this manner, a line of business can become an investment.

When forced to maintain an unwanted line of business, the acquirer may well leave pre-existing management in place since they have the expertise to run that business. Yet while the acquirer does not want to be burdened with running the unwanted business, it does have a strong incentive to engage in monitoring so as to insure that it receives full value when disposition of the asset ultimately occurs. Moreover, for administrative and regulatory reasons, the company may have little choice but to treat the unwanted division similarly to its other holdings and will therefore perform cash sweeps and issue consolidated reporting statements.

In short, the acquirer has good reason to engage in many of the activities highlighted by the Illinois court. Yet despite these factors, the unwanted business is still a separate entity being run by its own management. And crucially, none of these activities alters the fact that the acquirer's other holdings are in no way en-

riched by the addition of the unwanted asset to the corporate family. In constitutionally significant respects, it is a passive investment.

This Court's decision in the present case will have a significant impact on the state tax characterization of any gain or loss recognized upon the ultimate disposition of such unwanted assets. Under the unitary business and operational function tests as described in *Allied-Signal*, this sort of unwanted business could be acquired, held, and disposed of without generating apportionable income. This is appropriate because the asset neither increases the value of the company's other holdings nor operationally facilitates those other business activities. Sustaining the decision below, however, and endorsing the factors and analysis employed in reaching it, will likely convert the gain realized upon the eventual sale of this non-unitary business into apportionable income.

This outcome may in some cases effectively impose a tariff on otherwise desirable mergers. Companies deciding whether to acquire another corporation would have to factor in the negative tax consequences (perhaps in many states, if other states follow Illinois's lead) of holding on to a line of business that they might otherwise find undesirable, but that might provide an acceptable investment opportunity until the time was right to divest the holding. Presumably, some companies would find those tax consequences sufficiently adverse that they would resort to expensive and needlessly complicated arrangements such as internally reorganizing the structure of businesses or spinning off the unwanted entity. In short, the construction adopted below raises transaction costs and burdens business in a manner that serves no socially or eco-

nomically useful function. A constitutional rule that would inevitably yield such costs should be rejected.

IV. ADOPTION OF THE DECISION BELOW WOULD UPSET TAX AND BUSINESS DECISIONS MADE IN RELIANCE ON *ALLIED-SIGNAL*

The anticipated state tax consequences of mergers and acquisitions affect how those transactions are structured and priced. For fifteen years, a narrow construction of the operational function test, consistent with its articulation in *Allied-Signal*, has been relied on by business organizations throughout the country contemplating such transactions. Sustaining the Illinois court's decision in this case, even if it did not amount to a formal overruling of *Allied-Signal*, would repudiate that decision in effect and would certainly indicate that those companies had been dramatically wrong in their understanding of this Court's articulation of the constitutional limits on state apportionment. An affirmance would effectively penalize companies that structured transactions in the reasonable belief that, so long as they did not integrate subsidiaries and divisions into their primary business activities and did not exploit them operationally, they would not be expected to apportion any income generated by those subsidiaries.

This Court has previously taken cognizance of the reliance interests of businesses when adjudicating cases concerning the limits of state taxation. In *Quill Corp.* v. *North Dakota*, 504 U.S. 298, 316 (1992), this Court noted that businesses develop settled expectations in reliance on Supreme Court tax jurisprudence, and that the expectation of jurisprudential stability leads to beneficial investment and economic growth. Likewise, the *Allied-Signal* Court rejected New Jersey's challenge to the unitary-business principle in part

because "industry's reliance justifies adherence to precedent." 504 U.S. at 783 (citing *Quill Corp.*, 504 U.S. at 316).

Particularly, affirmance of the decision below could effectively result in multiple taxation, contrary to the uniform expectation of both taxpayers and states. In most circumstances, intangible income, such as capital gain from investments, traditionally has been treated as non-apportionable income, which may be taxed in its entirety by the taxpayer's state of domicile. *Allied-Signal*, 504 U.S. at 785; *Mobil Oil*, 445 U.S. at 445-446. A change in this treatment is likely to be resisted by domiciliary states, who understandably have come to rely on intangible income as a source of taxation. Thus, even as non-domiciliary states seek to tax an apportioned *share* of out-of-state intangible income on the ground that it serves an operational function, states of domicile may well seek to retain their right to tax *all* of that income. The inevitable consequence will be unfair multiple taxation and conflict among the states. This Court should avoid endorsing an approach to taxation that will have such negative consequences.

CONCLUSION

The decision of the Appellate Court of Illinois should be reversed.

Respectfully submitted.

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