

# PUBLICATION

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## U.S. Supreme Court Clarifies and Limits the "Operational Function"

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In a unanimous decision, the United States Supreme Court ruled on April 15, 2008 that the "operational functional" test articulated in earlier Supreme Court decisions did not create a separate and distinct ground for apportioning income to a state without a finding that the taxpayer's in-state business activities formed a part of a "unitary business." The ruling vacated an Illinois appellate court decision that permitted the state to tax an apportioned share of a \$1 billion capital gain realized by Mead Corporation, an Ohio-based company, on the sale of its business division known as Lexis/Nexis, an Illinois-based division. The Illinois Appellate Court ruled that Illinois could tax an apportioned share of the gain based on the fact that Mead's investment in Lexis/Nexis served an "operational purpose" in Mead's business even though the trial court determined that the two businesses were not unitary.

Over the years, the Supreme Court has adopted and applied a "unitary business" test to determine whether a state can include income from a corporation's out-of-state activities in the corporation's apportionable tax base. Under the "unitary business" concept, a state may not tax out-of-state business activity unless it is part of a single, unitary business with activity conducted within the state. The Supreme Court has described the "hallmarks" of a unitary business as "functional integrity, centralized management, and economies of scale."

The Illinois trial court ruled that Mead and Lexis/Nexis were not a unitary business because they lacked the hallmarks of a unitary business. Despite this finding, the trial court held that the gain was apportionable to Mead because Mead's investment in Lexis/Nexis served an "operational function" in Mead's business. The Illinois Appellate Court affirmed the lower court's application of the "operational function" test and never opined on whether Mead and Lexis/Nexis formed a unitary business.

In vacating the Illinois Appellate Court's decision, the Supreme Court stated that the "operational function" concept was "not intended to modify the unitary business principle by adding a new ground for apportionment," and "simply recognizes that an asset can be a part of the taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the payor and payee." Furthermore, the Supreme Court noted that the concept of "operational function" is merely relevant to the conclusion that an asset is a unitary part of the business being conducted in the state rather than a discrete asset to which a state has no claim. Said another way, the operational function test is not applicable to relationships between businesses.

According to the Supreme Court, the fatal flaw of the appellate court decision was the consideration of the operational function of the Lexis/Nexis division absent a finding that Mead and Lexis/Nexis were a unitary business. In order to uphold the tax on Mead, the two businesses had to first be found unitary. The Supreme Court remained silent on the application of the unitary business test to these two businesses and remanded the case back to the Illinois Appellate Court to determine its application.

Finally, the Supreme Court declined to consider the theory that Illinois had the authority to tax the gain based on the fact that Lexis/Nexis did substantial business in Illinois. This argument was first raised in Illinois' brief to the Supreme Court. Interestingly, the Court noted that Ohio and New York have both adopted this alternative rationale, but neither state appeared as an amicus in this case, and neither state was on notice that the constitutionality of its tax scheme was going to be an issue. Therefore, the Supreme Court decided that this question is "best left for another day."

