

MICHAEL AIKINS

Common Control and the Delineation of the Taxable Entity

ABSTRACT. This Note proposes a solution to what has been one of the most vexing problems in state corporate taxation and in multijurisdictional taxation generally: the delineation of the scope of the entity that an individual jurisdiction is entitled to tax. Starting from the observation that the federal government already aggregates the income of commonly controlled groups of corporations to prevent them from taking advantage of the lowest tax brackets multiple times, this Note proposes that states “piggyback” on these efforts and allow the federal government thereby to shoulder the burden of delineating the taxable entity.

AUTHOR. Yale Law School, J.D. expected 2012; University of Chicago, B.A. 2009. I would like to thank Daniel Hemel for his encouragement and advice; Jacob Goldin, Matthew Hegreness, Yair Listokin, Ruth Mason, Jeffrey Tebbs, and Edward Zelinsky for their suggestions; and Rachael Doud for her help throughout the editorial process. This Note is dedicated to my grandfather, George Aikins.



NOTE CONTENTS

INTRODUCTION	626
I. AN INTRODUCTION TO THE PROBLEM	629
A. Apportionment and Combined Reporting	629
B. Unitary and Nonunitary Businesses	634
C. The Constitutional Dimension	635
II. THE UNITARY BUSINESS TEST	637
A. The Unitary Business Test Is Fact-Intensive and Costly To Administer	640
B. The Unitary Business Test Is Arbitrary	642
C. The States Differ in Their Application of the Unitary Business Test	647
III. THE COMMON CONTROL TEST	650
A. An Outline of the Common Control Test	651
B. Benefits of Adopting the Common Control Test	654
C. Why the Common Control Test Is Superior to the Affiliated Groups Test	657
D. Predecessors of the Common Control Test	660
IV. COUNTERARGUMENTS	663
A. The Constitutionality of the Common Control Test	663
B. Tax Avoidance Opportunities Under the Common Control Test	668
C. Barriers to Implementation	673
CONCLUSION	676

INTRODUCTION

Where income is earned by operations spanning multiple jurisdictions, taxing that income involves (very roughly) a determination of: (1) the scope of the business whose profits are considered in levying a tax, and (2) what proportion of those profits are taxable by the jurisdiction at issue.¹ This Note is concerned exclusively with the first of these problems: how a state draws the line around the entity whose profits it considers in taxing. Despite considerable scholarly attention, this remains “the great unsolved problem”² in state corporate taxation.

This Note proposes a novel solution that would have the states “piggyback” on a test currently used by the Internal Revenue Code to treat the profits of related entities in the aggregate.³ The idea is simple. The federal government

-
1. This is under an “apportionment scheme,” where the aggregate income of the business is apportioned among jurisdictions, as is the case in the United States and Canada. Much has been written recently on the European Union moving to the American model. See, e.g., Joann Martens Weiner, *Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada* (Eur. Comm’n, Directorate-Gen., Taxation & Customs Union, Working Paper No. 8, 2005).
 2. Jerome R. Hellerstein, *The Basic Operations Interdependence Requirement of a Unitary Business: A Reply to Charles E. McLure, Jr.*, 18 TAX NOTES 723, 730 (1983). This is “an issue that has been confounding state tax practitioners for almost half a century.” Lloyd J. Looram, Letter to the Editor, *Recent U.S. Supreme Court Decision Did Little To Clarify Unitary Business Test*, 48 ST. TAX NOTES 603, 603 (2008).
 3. To the author’s knowledge, no commentator has recommended that the states piggyback on the federal common control test. Although the benefits of piggybacking on the administration of the federal income tax are well recognized, the desirability of piggybacking on this portion of the Internal Revenue Code has escaped notice. This is likely because the problem dealt with at the federal level (fragmenting profits among entities) is not obviously related to the delineation of the taxable entity at the state level.

Other ownership-based standards for delineating the taxable entity have been proposed, however. See, e.g., Eugene F. Corrigan, *Toward Uniformity in Interstate Taxation*, 11 TAX NOTES 507 (1980) (suggesting a majority ownership test); Peggy B. Musgrave, *Principles for Dividing the State Corporate Tax Base*, in THE STATE CORPORATION INCOME TAX 228, 237 (Charles E. McLure, Jr. ed., 1984) (suggesting a 50% ownership test); see also William David Dexter, *The Unitary-Business Principle Revisited: Restrictions on Its Use*, 8 J. ST. TAX’N 205, 213 (1989) (suggesting an ownership-based standard specifically for multinational businesses). Indeed, Frank Keesling, who developed what is still a widely used formulation of the unitary business test, eventually came to the belief that an ownership-based standard would be the only administrable way of delineating the taxable entity. Frank M. Keesling, *The Combined Report and Uniformity in Allocation Practices*, in MULTISTATE TAX COMM’N, SEVENTH ANNUAL REPORT 42-43 (1975). Some scholars have also suggested that the states adopt the standard that is used by the federal government to determine eligibility to file a consolidated federal return, which is ownership-based. See, e.g., S. C. Nemeth, Jr. &

already combines the income of related entities so that businesses cannot funnel their profits into multiple subsidiaries to take advantage of the lowest corporate tax rates. States could piggyback on these efforts, treating the commonly controlled group—as determined for federal tax purposes—as the taxable entity for state purposes.

Currently, the states use the “unitary business test” to delineate the taxable entity. Under this test, where the business in question shows a sufficient degree of integration and interdependence with operations in the taxing state, that state can levy a tax on a portion of the business’s aggregate earnings. Thus, for instance, if a lumber mill in Vermont was sufficiently integrated with a pulp and paper plant in Connecticut, Vermont could tax a portion of the profits earned by the entire operation.

Although simple enough to articulate, the unitary business test has proven extremely burdensome to administer. The test requires a fact-intensive inquiry into the workings of interstate businesses because absolutely everything—from joint financing, to management overlap, to use of intellectual property—is relevant to the analysis. Moreover, determining what degree of integration is sufficient to satisfy the test is a matter of judgment, and reasonable minds disagree in all but the clearest of cases. The test has therefore offered little guidance to businesses about the tax consequences of their operations. Compounding these difficulties, the states often disagree about whether a given business is unitary, which results necessarily in either double taxation of certain corporate profits or else in no taxation at all of those profits (“nowhere income,” in tax parlance).

For these reasons, the test has been widely disparaged by both commentators and tax administrators. In the context of European Union tax integration, where the experience of the American states has been heavily drawn upon as a parallel, commentators have largely rejected imitation of the unitary business test.⁴ And in a 1992 case, the Supreme Court considered the

H. O. Agee, Jr., *State Taxation of Multistate Business: Resolution or Stalemate?*, 48 TAXES 237, 248 (1970) (noting that there have been suggestions to use the federal standard); Robert P. Strauss, *Federal Collection of State Corporate Income Taxes*, in STATE TAXATION OF BUSINESS: ISSUES AND POLICY OPTIONS 69, 73 (Thomas F. Pogue ed., 1992) (suggesting use of the federal standard for consolidated reporting).

4. See Christine Obermair & Patrick Weninger, *General Report*, in MICHAEL LANG ET AL., TAX COMPLIANCE COSTS FOR COMPANIES IN AN ENLARGED EUROPEAN COMMUNITY 17, 45 (2008); Walter Hellerstein & Charles E. McLure, Jr., *The European Commission’s Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, 11 INT’L TAX & PUB. FIN. 199, 205-06 (2004). But see Ana Agúndez-García, *The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options* 13 (Eur. Comm’n, Directorate-Gen., Taxation &

arguments of tax administrators from New Jersey that the test was unworkable, though the Court declined to abandon it.⁵

The unitary business test is seen by most as a kind of necessary evil: an evil for the reasons listed above, and necessary both because no workable alternatives have been put forward and because an inquiry into the economic substance of these businesses is thought to be necessary to prevent states from taxing profits generated by activities unconnected to the taxing state—a violation of the Fourteenth Amendment’s Due Process Clause.

This Note offers a formal solution to the problem and contends that this solution does not run afoul of the Constitution. The idea was inspired principally by the observation that the federal government is already engaged in a kind of delineation exercise of its own. The federal government uses an objective, ownership-based rule for aggregating the income of related entities to prevent businesses from fragmenting themselves into multiple corporations in order to take advantage of lower tax brackets and multiply the number of certain deductions and credits to which they would otherwise be entitled. The problem encountered at the federal level (income-spreading among many entities) bears a resemblance to the problem of profit-shifting to states with low taxes, and the solution to both problems involves aggregating the income of the entities involved so as to render moot the profit-shifting in question.

Beginning with this conceptual parallel, this Note argues that the states should use the administration of the federal common control test to delineate the scope of the entities they tax. This shift would produce a number of important advantages. First, it would allow the states to “outsource” the costs of refining and administering the test to the federal government. Second, it would achieve uniformity (*the sought-after value in interstate taxation*), as well as greater objectivity and predictability. Third, it would increase the stability of state revenues in times of local or regional economic volatility.

Use of the common control test would not violate the Due Process Clause. The constitutional objection hinges entirely on the possibility that commonly controlled entities would be swept into the taxing power of a state even though these entities lack the economic integration and synergy with activities in that state that would justify extension of its taxing power. This Note offers reasons to believe that this will rarely be the case. Common ownership always creates certain synergies between businesses, and the market for corporate control ensures that other, particularized synergies will exist. We can also assume that

Customs Union, Working Paper No. 9, 2006) (arguing that the EU would be better served by adopting a version of the unitary business test rather than a formal alternative).

5. See *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992).

synergies between commonly controlled entities will be sufficiently large as to outweigh the disadvantage that the group incurs at the federal level by being denied double use of the lowest bracket and other benefits—otherwise the entities would not be commonly owned. Any remaining concerns as to extraterritorial taxation could be mitigated by including relief provisions that allow taxpayers to challenge particular applications of the common control test.

The argument proceeds as follows. Part I introduces the mechanics of state corporate taxation that are essential to understanding this Note's proposal. Part II explains why the unitary business test is unadministrable. Part III argues that states should adopt the federal common control test and shows why this test is a superior choice to the federal affiliated groups test. Part IV addresses three counterarguments: first, that adoption of the common control test would result in taxation of profits unconnected to the taxing state in violation of the Due Process Clause; second, that the formalism of the common control test invites manipulation because the test's ownership standard is a fixed target around which tax planners will be able to structure; and third, that states will be unwilling or unable to adopt the common control test unilaterally. The Note then concludes.

I. AN INTRODUCTION TO THE PROBLEM

The common control test is a means by which states can simply and objectively delineate the entity whose profits they consider in taxing. It should be thought of as an improvement of one part of the entire mechanism by which states tax interstate businesses. In order to situate the improvement, then, a description of this mechanism is necessary. This Part thus presents as brief an overview as possible of apportionment, combined reporting, and the distinction between unitary and nonunitary businesses. It can be skipped by the reader who is already familiar with these concepts.

A. Apportionment and Combined Reporting

Two great problems underlie and animate—and therefore also explain—much of the unique structure of state corporate income taxation. First, states must decide how to divide up the income of interstate businesses when that income often arises from integrated operations and thus cannot be separated and attributed to discrete geographic areas. Second, states must prevent interstate businesses from manipulating transfer prices or using other mechanisms to shift their profits from high-tax to low-tax states. Apportionment and combined reporting are two mechanisms by which these problems are addressed, and are briefly outlined in turn here.

Let us begin with a simple (and stylized) example: a timber operation in Oregon provides wood to a furniture manufacturer in Washington whose goods are then sold at stores in Connecticut. The whole operation has centralized financing, advertisement, and management and is owned by a corporation with headquarters in New York ("X Corp."). Which of these four states should be allowed to tax what proportion of the \$10 million in profits that the corporation as a whole reports? Where the enterprise generates its profits as an integrated and interdependent whole—as an "organic system," in the words of Justice Holmes⁶—it is impossible to disaggregate the contributions that its parts make to overall profitability.⁷ The business has intra-enterprise synergies (for example, lower costs of capital because of the corporation's total assets) and centralized costs (for example, advertising and management salaries) that are all but impossible to allocate geographically.⁸ What state, for instance, should bear the cost of national advertising? One might think that the sales operation in Connecticut should naturally bear that cost, but if advertising raises sales, then it will also lead to an increase in the production of the timber and manufacturing operations, thereby potentially lowering their marginal costs and increasing their profitability.⁹ All parts of the enterprise are necessary to realize its profits, and thus any ascription of profits to particular functional or geographic subunits is bound to be somewhat arbitrary.

Separate geographic accounting, which seeks to treat operations in one state as distinct from those in another and to price the transfers across these operations, cannot provide an adequate account of where profits are earned. Pricing intrafirm transactions gives rise to a host of difficulties,¹⁰ and—as has

-
6. *Wallace v. Hines*, 253 U.S. 66, 69 (1920). Justice Holmes was referring in *Wallace* to the justifications that a state might have for levying property taxes based on the value of the entirety of an interstate enterprise. "The only reason," wrote Holmes, "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, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess." *Id.*
 7. The income from such a business "cannot sensibly be reduced to the sum of the hypothetical incomes of distinct component parts, each wrenched from the unitary whole and conceptually confined to operations within a single State." *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 333 (1982) (O'Connor, J., dissenting).
 8. See GEORGE T. ALTMAN & FRANK M. KEESLING, *ALLOCATION OF INCOME IN STATE TAXATION* 94-96 (1946).
 9. *Id.*
 10. See, e.g., COMPTROLLER GEN., U.S. GEN. ACCOUNTING OFFICE, GGD 81-81, *IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS: REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS OF*

been noted—many intra-enterprise costs like advertising cannot be satisfactorily located geographically.¹¹ Moreover, separate accounting allows corporations easily to shift their profits to low-tax states by manipulating transfer prices. Taking the above example, X Corp. would have an incentive to set a high price on the furniture “sold” from its manufacturing arm in Washington to its store in Connecticut because Connecticut has a higher corporate income tax. Policing this kind of manipulation is not only costly but impossible for many goods because accurate transfer prices cannot be determined.¹² For these reasons, there has long been a consensus that separate accounting is an inadequate method of allocating the profits of interstate businesses.¹³

Recognizing the impossibility of geographically locating the profits of interstate businesses, most states apportion the income of these businesses based on the proportion of sales, tangible property, and/or payroll that the business has in the state. The theory behind this apportionment scheme is that these factors are rough proxies for the amount of activity that an entity conducts in a given state and thus also for the proportion of profits that can be fairly allocated to that state.¹⁴ The more sales, property, or employees a business has in a given state, the greater the proportion of profits assumed to be “derived” from that state. Some states use a combined metric of all three factors, while others apportion on the basis of sales alone.¹⁵ Although apportionment is admittedly imperfect, it has been widely accepted as an

THE U.S. (1981) (finding that decades of efforts of the IRS to use I.R.C. § 482 to separate U.S. income from foreign income have not been effective); Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79 (2008) (criticizing the § 482 transfer pricing regime as applied to intangible assets). Section 482 allows the Service, inter alia, to readjust transfer prices between commonly controlled entities to prevent tax avoidance via transfer price manipulation.

11. See ALTMAN & KEESLING, *supra* note 8, at 94.
12. *Id.* at 92-96.
13. See Charles E. McLure, Jr., *Defining a Unitary Business: An Economist's View*, in THE STATE CORPORATION INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION 89, 89 (Charles E. McLure, Jr. ed., 1984).
14. See Benjamin F. Miller, *Worldwide Unitary Combination: The California Practice*, in THE STATE CORPORATION INCOME TAX, *supra* note 13, at 132, 132.
15. See JOSEPH F. ZIMMERMAN, THE SILENCE OF CONGRESS: STATE TAXATION OF INTERSTATE COMMERCE 81-82 (2007). A few states also apportion on the basis of some two of the three factors. *Id.*

administratively convenient and reasonably accurate solution to the problem of dividing up the income of interstate businesses.¹⁶

Even with apportionment, however, states encounter anew the dual problems of dividing up income and avoiding manipulation where interstate enterprises are composed of multiple corporate entities. Imagine that X Corp. in the above example is one of three furniture-making outfits operating in the United States, all of which are owned by, and pass on their profits as dividends to, a single corporation in Nevada ("Z Corp."). Should Connecticut seek to tax a portion of only X Corp.'s profits or of the entirety of Z Corp.'s profits? If the three furniture-making corporations operate in a similarly interdependent and integrated way as the constituent parts of X Corp., then splitting the profits among these corporate entities will be no easier than it was among the manufacturing and sales arms of X Corp.¹⁷ If we could not, for instance, satisfactorily allocate advertising expenses among the integrated parts of X Corp., then we will not be able to do so among the three integrated corporations owned by Z Corp. The mere fact of separate incorporation does not make separation of profits any easier.

Some states nevertheless do respect the separate accounting of corporate entities and will only tax the profits that are reported by a corporate entity operating within the state. (This practice is analogous to the separate *geographic* accounting criticized above, but uses corporate, as opposed to geographic, boundaries.) Applying this accounting scheme to the above example, Connecticut would tax only the income from X Corp. This separate accounting also leaves states vulnerable to transfer price manipulations and other means of shifting profits from high-tax states to low-tax states.¹⁸ Let us assume that Z

16. See Miller, *supra* note 14, at 132. This Note does not deal with the distinction states draw between business and nonbusiness income and, for simplicity, assumes throughout that all income is allocable business income. (Only business income is apportioned; nonbusiness income is allocated to a single state, usually on the basis of the location of the property that gave rise to the income or the business's commercial domicile.) For a critique of this distinction, see Walter Hellerstein, *The Business-Nonbusiness Income Distinction and the Case for Its Abolition*, 21 ST. TAX NOTES 725, 725-36 (2001).

17. See Frank M. Keesling & John S. Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42, 58 (1960) (describing the natural progression in California tax law from apportionment of the income of unitary corporations to apportionment of the income of enterprises consisting of multiple corporations).

18. See Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, in THE FUTURE OF STATE TAXATION 49, 62 (David Brunori ed., 1998) ("A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers. Transfer pricing, holding companies, and more subtle and less notorious strategies exist for exploiting separate entity states.").

Corp. owns the rights to the brand name under which its three furniture-making subsidiaries operate. X Corp. could then pay the parent corporation inflated fees for the use of this intellectual property, thus decreasing its profitability and increasing the profitability of the parent company, which, because it is located in Nevada, pays no state income taxes.¹⁹

In response to these and other schemes, a majority of the states that impose corporate income taxes have mandated “combined reporting,”²⁰ which requires commonly owned corporations engaged in an integrated and interdependent business—a “unitary business”—to report their profits in the aggregate, regardless of the location in which they were purportedly earned. Intercorporate transactions (most importantly the payment of dividends) are eliminated, and the state taxes a portion of the combined income of the entire group. This tax, however, is only levied on those corporations with a connection or “nexus” to the taxing state.²¹ Thus, if X Corp. in Connecticut and Y Corp. in California are engaged in a unitary business but only X Corp. has a nexus to Connecticut, X Corp. will be taxed by Connecticut on the basis of the combined earnings of the two corporations; Connecticut does *not* levy a tax on both corporations. In essence, combined reporting broadens the entity whose profits are considered beyond the artificial boundaries of a single corporation. Combining the profits of entities defeats the aim of shifting profits from one commonly owned entity to another.

Apportionment and combined reporting are thus the two principal mechanisms by which the states attempt to accurately divide up the profits of interstate businesses and keep those businesses from shifting profits from high-tax to low-tax states. These mechanisms have in common the forcible consideration of profits that were purportedly earned outside of the state (that is, according to the business’s internal accounting).

It is important to be perfectly clear at the outset what is at stake when a state forces this inclusion. Inclusion does *not* mean that the taxing state always earns more revenue. If a business’s separate accounting shows profits of \$1

19. To take a real world example, Toys “R” Us placed intellectual property in its subsidiary, Geoffrey Inc., a shell company incorporated in Delaware. Toys “R” Us then paid licensing fees to Geoffrey Inc., thereby shifting profits from high-tax states to a low-tax state. See Prem Sikka & Hugh Willmott, *The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness*, 21 CRITICAL PERSP. ON ACCT. 342, 352 (2010).

20. Michael Mazerov, *A Majority of States Have Now Adopted a Key Corporate Tax Reform—“Combined Reporting,”* CTR. ON BUDGET & POL’Y PRIORITIES (Apr. 3, 2009), available at www.cbpp.org/4-5-07sfp.pdf.

21. See John J. McIntyre, *The Use of Combined Reporting by Nation States*, 35 TAX NOTES INT’L 917, 919 (2004).

million in Connecticut and \$500,000 in New Jersey, for instance, then including the New Jersey profits in the Connecticut return does not mean that Connecticut gets to tax the full \$1.5 million. Rather, Connecticut taxes \$1.5 million multiplied by the proportion of the business's operations (sales, payroll and property) located in Connecticut. Suppose this proportion is 50% (i.e., the business has equal sales, payroll and property in the two states); then Connecticut can tax only \$750,000. If the proportion is 80%, then Connecticut can tax \$1.2 million. Compare these figures to the \$1 million that the state would have been able to tax if it had not considered the New Jersey income, and we see that including portions of a business outside of the taxing state might either increase or decrease that state's tax revenue. Where a business's books show that the out-of-state portion of the business is of greater profitability (i.e., the profit to sales/payroll/property ratio is higher) then it will be to the state's advantage to include this portion; if not, not.²²

B. Unitary and Nonunitary Businesses

Up to this point, this Note has dealt only with enterprises—whether operating as single or multiple corporations—that are integrated and interdependent. These businesses are referred to as “unitary” businesses. One could imagine, however, two parts of a corporation or two corporations in a conglomerate operating so independently of one another that separating their profits would be easy and there would be little risk of profit-shifting (because of the paucity of transactions) from high-tax to low-tax states—in other words, a situation in which the two problems that led to apportionment and combined reporting are not present.

Let's take an orange grove in California and a grocery store in Connecticut that are run by two different people and have no transactions between them whatsoever—not a shred of management advice, financing, or advertisement. If the grove and the grocery store are part of the same corporation, there would seem to be little justification for apportioning the income of the whole corporation to the two states; it would be more accurate to allow California to tax the grove and Connecticut the grocer. Similarly, if the grove and the grocer are separately incorporated and commonly owned by a third corporation, there would seem to be no justification for requiring the conglomerate to file a

22. In other words, “[t]he presence of a unitary business is favorable [to the taxpayer] when losses of unprofitable affiliates may be offset against the earnings of profitable affiliates, and when income earned in a high-tax state may be shifted, due to the use of combined apportionment factors, to low-tax states.” Karen J. Boucher, *Multistate Corporate Tax-Saving Strategies: Part 2*, 12 J. ST. TAX'N 23, 39-40 (1993).

combined report aggregating the income of the two commonly owned corporations; rather, each state should tax only the corporation operating within its borders. We thus see that the economic and administrative justifications for aggregating and apportioning the profits of an interstate business exist *only where that business is unitary*.

C. *The Constitutional Dimension*

There is one final and important piece that needs to be put in play in order for the problem to be fully set up: the constitutional dimension. States are led not only by economic logic to differentiate between unitary and nonunitary businesses; they are constitutionally compelled to do so. The Supreme Court has held that the Due Process Clause of the Fourteenth Amendment forbids states from apportioning the profits of an interstate business unless those profits were earned by a unitary business operating (at least in part) within the borders of the taxing state.²³

Under the Fourteenth Amendment's Due Process Clause, there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."²⁴ The Due Process Clause is thus often said to forbid "extraterritorial taxation."²⁵ If a state could simply reach out and tax the profits of a business operating solely in another state, mayhem would quickly engulf our federal system.

When California and other states introduced apportionment as a means of dividing up the income of interstate businesses, corporations challenged the innovation as a violation of the Due Process Clause.²⁶ In these challenges,

23. While the dormant Commerce Clause provides independent restrictions on the apportionment schemes of the states, the Supreme Court has held that these restrictions are substantially the same as those imposed by the Due Process Clause. See *Ott v. Miss. Valley Barge Line Co.*, 336 U.S. 169, 174 (1949); see also Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 *TAX LAW.* 37, 52 (1987) (discussing this interchangeability). Because most modern Supreme Court cases that deal with apportionment (including those discussed in this Note) have been decided under the Due Process Clause, I omit what would otherwise be a redundant discussion of the Commerce Clause.

24. *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45 (1954).

25. See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 271-72 (1978).

26. The Supreme Court's earliest cases on this issue were property tax cases that dealt with railroad, telegraph, and express companies. In a series of cases dealing with constitutional challenges to state property taxes levied on these enterprises, the Supreme Court held that states could tax a portion of the entire value of the interstate business, so long as that business was "unitary." See, e.g., *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194

corporations would claim that a given state had allocated to itself a disproportionately large share of the profits of the interstate enterprise and had thus taxed extraterritorial income. The corporation would invariably assert, on the basis of its own internal, state-by-state, separate accounting, that the taxing state had overestimated the portion of the company's profits that were generated by in-state activities. In *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*,²⁷ for instance, an interstate tanning operation argued that its manufacturing activities in North Carolina accounted for a much smaller proportion of its profits than North Carolina had taxed. In upholding North Carolina's and other states' apportionment schemes, the Supreme Court stressed the fact that, because the businesses in question operated as integrated wholes, allocation with "mathematical exactness" was an impossibility.²⁸ So long as the business was unitary, the Court held that the entirety of its profits could be apportioned based on a reasonable formula.²⁹ But if activities were a part of a discrete business operating outside of the state—even if the activities were a part of a corporation or conglomerate of corporations doing business in that state—the profits deriving from these activities could not be apportioned and taxed by the state. This has come to be known as the "unitary business test" and has been held by the Court to be the "linchpin of apportionability."³⁰

The Supreme Court thus tailored its Due Process Clause jurisprudence to the realities and limitations of taxing interstate businesses; a method of apportionment that was convenient and administrable was held to be constitutional (so long, that is, as the method came reasonably close to tracking what the Court considered the underlying economic structure of the interstate

(1897); *Pullman's Palace Car Co. v. Pennsylvania*, 141 U.S. 18 (1891). The Court reasoned that, because the value of the whole business was greater than the sum of its parts, a state could only arrive at a proper valuation of the business's in-state property by looking at the value of the entire business and then taxing a fair portion of this value. This reasoning was extended to income taxes in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). On the origins of the unitary business test, see generally James H. Peters & Benjamin F. Miller, *Apportionability in State Income Taxation: The Uniform Division of Income for Tax Purposes Act and Allied-Signal*, 60 TAX LAW. 57, 60-66 (2006).

27. 283 U.S. 123 (1931).

28. *Id.* at 134; see also *Underwood Typewriter*, 254 U.S. at 121 (states face the "impossibility of allocating specifically the profits earned by the processes conducted within [their] borders").

29. Under the Due Process Clause, the unitary business (but *not* each constituent corporation) must also have a *de minimis* degree of presence in the taxing state to establish a nexus. How to measure this presence is itself a subject of controversy and will not be addressed by this Note. For a general discussion of the issue, see Quinn T. Ryan, Note, *Beyond BATSA: Getting Serious About State Corporate Tax Reform*, 67 WASH. & LEE L. REV. 275, 286 (2010).

30. *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 439 (1980).

business in question). It was economic exigency that led the states to create the apportionment scheme, and the Court drew the constitutional line—the bounds of the Due Process Clause’s “fundamental fairness”³¹ requirement—around the scheme that the states had created.³² The constitutional and the economic question thus became two sides of the same coin: whether an enterprise is sufficiently integrated as to require apportionment or combined reporting of its profits is the same question as whether a state has a sufficient connection to the entirety of the enterprise that it is constitutionally able to tax an apportioned part of its aggregate profits.³³ The question is whether or not the business at issue is unitary.

II. THE UNITARY BUSINESS TEST

In deciding whether a given business is unitary, the approach of the states and the Supreme Court has been to look at the underlying economic structure of the business. This Part will argue that this approach is futile and costly. The general aim here is both to motivate the adoption of the common control test proposed in the next Part and to gather together the strands of a systematic critique of the status quo.³⁴

-
31. *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992) (noting in the context of a challenge to a state tax that “[d]ue process centrally concerns the fundamental fairness of governmental activity”).
 32. It should be noted that some states make less aggressive use of the unitary business test. That is, they “draw their line” somewhat inside of the constitutional limit. See *infra* Section II.C for a discussion of the differences among states in this respect. Recall also that the unitary concept comes in part from the Supreme Court’s own cases on railroads. See *supra* note 26.
 33. This parallel is reflected in the fact that Professor Charles McLure, reasoning entirely from economic (and not legal) premises, arrived at a definition of a unitary business that is essentially the same as the constitutional standard promulgated by the Supreme Court. See McLure, *supra* note 13 at 89-90.
 34. The unitary business test has been frequently criticized by scholars. See James F. Buresh & Marc S. Weinstein, *Combined Reporting: The Approach and Its Problems*, 1 J. ST. TAX’N 5, 7-8 (1982) (criticizing the test as vague); Peter Miller, *State Income Taxation of Multiple Corporations and Multiple Businesses*, 49 TAXES 102, 109-10 (1971) (criticizing the test as vague and subjective, allowing tax administrators to overreach); Robert P. Mohan, *The Unitary Concept Today*, 5 J. ST. TAX’N 57, 64 (1986) (criticizing the test as vague and difficult to administer and to comply with); Nemeth & Agee, *supra* note 3, at 247-48 (criticizing the test as vague and subjective and noting that it is impossible to establish criteria for administering the test); Ferdinand P. Schoettle, *Big Bucks, Cloudy Thinking: Constitutional Challenges to State Taxes—Illumination from the GATT*, 19 VA. TAX REV. 277, 313 (1999) (criticizing the test as costly and offering an incentive to tax administrators to default to

In determining whether a given business is unitary, the Supreme Court has stressed the importance of “unity of use and management of a business,”³⁵ and of integration across the business such that “all the factors in th[e] enterprise are essential to the realization of profits.”³⁶ In *Mobil Oil Corp. v. Commissioner of Taxes*,³⁷ the Court laid out the modern framework for the concept, finding that unitary businesses are characterized principally by three qualities: “functional integration, centralization of management, and economies of scale.”³⁸ This tripartite definition has been reiterated by the Court in every significant decision on the issue since *Mobil*.³⁹ The essence of the *Mobil* standard—and also of the various standards articulated by commentators⁴⁰ and by state courts⁴¹—is the existence of synergies or “flows of value”⁴² that arise

findings of unity); Robynn J. Wilson, *Managing a Unitary Audit*, 21 J. ST. TAX’N 84, 84-86 (2002) (noting the disagreement among courts as to how to define the unitary business).

35. *Butler Bros. v. McColgan*, 315 U.S. 501, 508 (1942).
36. *Hans Rees’ Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 133 (1931).
37. 445 U.S. 425 (1980).
38. *Id.* at 438.
39. *See MeadWestvaco Corp. v. Ill. Dep’t of Revenue*, 553 U.S. 16, 30 (2008); *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 781 (1992); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 179 (1983); *F. W. Woolworth Co. v. Taxation & Revenue Dep’t*, 458 U.S. 354, 364 (1982); *ASARCO Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 317 (1982); *Exxon Corp. v. Wis. Dep’t of Revenue*, 447 U.S. 207, 222 (1980).
40. *See* ALTMAN & KEESLING, *supra* note 8, at 101 (“The essential test is whether or not the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state.”). Jerome Hellerstein put forward a test for unity that would hinge on whether “basic operations are carried on to a substantial extent in different States by the branches or subsidiaries that comprise the controlled enterprise.” Jerome R. Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 ST. TAX NOTES 155, 165 (1982). This test seems to be nothing more than a unitary business “light,” and would involve large uncertainty in distinguishing between basic and nonbasic operations (something Hellerstein admirably admits) and in determining what amounts to a “substantial extent.” There is also a strong likelihood that transactions involving nonbasic operations would be manipulated in order to transfer income, and so states would have to scrutinize the fairness of these transactions—with all of the problems attendant to such an analysis. Hellerstein’s test has also been critiqued on other grounds. *See* Charles E. McLure, Jr., *Operational Interdependence Is Not the Appropriate “Bright Line Test” of a Unitary Business—At Least, Not Now*, 18 ST. TAX NOTES 107, 107 (1983).
41. *See, e.g., Edison Cal. Stores, Inc. v. McColgan*, 183 P.2d 16, 21 (Cal. 1947) (“If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary”); *Crawford Mfg. Co. v. State Comm’n of Revenue & Taxation*, 304 P.2d 504, 510 (Kan. 1956) (“The test is whether a business’s various parts are interdependent and of mutual benefit so as to form one business rather than several business entities”); *John I. Haas, Inc. v. Ellis*, 361 P.2d

from the connectedness of a business and that cannot accurately be reflected in separate geographic accounting.

Despite the doctrinal clarity in this area, the unitary business test has proven extremely difficult to administer. Determining whether there are flows of value within an interstate business is a fact-intensive and costly endeavor. Deciding how significant these flows of value are and at what point they make a business unitary is a matter of judgment, and reasonable minds will disagree in all but the clearest of cases. Because the test turns on the specific facts of a case and the judgment of a tax administrator or judge, it has offered little guidance to businesses about the tax consequences of their operations. Exacerbating all of these difficulties, the states have differing articulations of the unitary business test and often disagree about whether a given business is unitary.

The leading commentator in the field has noted that “the Court’s approach to the unitary business issue . . . , with its painstaking scrutiny of the record, leaves one with the sense that whatever the broad principles to which it pays homage, the unitary business in the end may simply be something that the Court knows when it sees it.”⁴³ As a test that must reliably guide the activities of the business community, and must be applied by state tax collectors and judges to thousands of interstate businesses every year, this kind of arbitrary standard should be unacceptable.⁴⁴

820, 822 (Or. 1961) (“The term ‘unitary business’ means that the taxpayer to which it is applied is carrying on a business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration as independent units.” (quoting 1959 Or. Tax Reg. 4.280(1)-(B))).

42. See *Container Corp.*, 463 U.S. at 178 (“The prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*, not a flow of goods.”).
43. Walter Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on ASARCO and Woolworth*, 81 MICH. L. REV. 157, 183-84 (1982). This “standard” was made famous in Justice Potter Stewart’s concurrence in *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Potter, J., concurring), dealing with the definition of “hard-core pornography.”
44. It is perhaps instructive on this score to note that the Supreme Court eventually clarified its obscenity jurisprudence in *Miller v. California*, 413 U.S. 15 (1973), with the introduction of a more concrete test, which looks to:
 - (a) whether “the average person, applying contemporary community standards” would find that the work, taken as a whole, appeals to the prurient interest; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value.

Id. at 24 (citation omitted).

A. *The Unitary Business Test Is Fact-Intensive and Costly To Administer*

State income taxation piggybacks to a large extent on the administration of the federal income tax—on congressional lawmaking, Treasury Department regulations, court decisions, and IRS auditing and enforcement. Because the federal government already measures and enforces an income tax on businesses and individuals, the states are able to free ride on its efforts by pegging their own calculations of income—with some exceptions and caveats—to those of the federal government.⁴⁵ This free riding is critically important because the states do not have the resources to independently administer a full-fledged net income tax, nor to audit taxpayers and enforce compliance with their taxes.⁴⁶ But because the unity of an interstate business is of concern only to the states, there is no federal lawmaking or auditing on which the states can piggyback. (Whether operations in one state are integrated with those in another is of no significance to a federal income tax that catches in its net the profits earned in every state.) Because the states must go it alone, then, it is important to have a method of determining unity that is cheaply and easily administrable. The unitary business test unfortunately is anything but.

Recall that the Supreme Court's *Mobil* standard requires an analysis of the degree of "functional integration, centralization of management, and economies of scale,"⁴⁷ and that the ultimate test is whether there are flows of value between the relevant portions of a business. This is acknowledged by all to be a highly fact-intensive inquiry. It requires tax commissioners and courts to dig into the workings of an interstate business and to try to tease out how and to what extent its parts interoperate and depend on one another. In an attempt more clearly to delineate the test, the Multistate Tax Commission created a non-exhaustive list of twenty-five different factors that should be taken into account.⁴⁸ The lesson to be drawn from this attempt is that absolutely everything—from a business's capital structure to its financing to its purchases

45. For more on this piggybacking, see generally JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶ 7.02 (3d ed. 2010), discussing the varying ways in which, and extents to which, states piggyback on the federal administration of taxes; and Michael C. Dorf, *Dynamic Incorporation of Foreign Law*, 157 U. PA. L. REV. 103, 108-10 (2008), cataloguing the states that automatically incorporate changes in the federal income tax code and discussing the benefits and drawbacks of piggybacking.

46. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 7.02[4] ("[S]tate tax administrators generally have neither large enough staffs nor sufficient expertise to perform full-scale independent audits of the books and records of large corporations.").

47. *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 438 (1980).

48. MULTISTATE TAX COMM'N, SEVENTH ANNUAL REPORT 57 (1975).

of goods and services to the degree of control exercised by its management—is relevant to the analysis. Litigation over findings of unity are drawn out and expensive because “[t]he factual records in such cases, even when the parties enter into a stipulation, tend to be long and complex.”⁴⁹ This complexity will become abundantly clear in the discussion of the *ASARCO* case in the following Section.

Moreover, even if the court or tax administrator has the time and patience to dig into the operations of the business in question, many of the flows of value or synergies that are relevant to the unitary business analysis are difficult or impossible to identify. Indeed, the difficulty of identifying and quantifying these flows is a large part of why separate accounting is inadequate and why apportionment is necessary in the first place. It may be easy enough to single out exchanges of goods between two parts of a business, but other flows of value—such as the goodwill that is jointly created and enjoyed, or the lower costs of financing that result from affiliation, or advice that is exchanged without remuneration—are much more elusive. To return to the example of the orange grove and the grocery store, a wholesaler might be willing, for instance, to extend purchase money credit on more favorable terms to the grocery store because it knows that the store is part of a corporation that also owns an orange grove.⁵⁰ Thus, the grocery store’s profitability may be increased by its affiliation with the orange grove. But how could a court or a tax administrator know this? Where an asset (here, the orange grove) is not actually being used as collateral for a loan, it can be very difficult to discern whether and to what extent ownership of the asset affects the terms of financing.⁵¹

Another example of an elusive flow of value is the degree of management control exerted over a subsidiary—one of the three factors of the *Mobil* test.

49. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 176 (1983); see also Wilson, *supra* note 34, at 89-91 (cataloguing the myriad documents requested in unitary audits). A lawyer for the New Jersey Tax Division, seeking to eliminate the unitary business test, spoke for tax administrators everywhere when she noted in an oral argument before the Supreme Court: “We can’t delve into these facts in every one of these cases. It’s an unworkable proposition.” Transcript of Oral Argument at 38, *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992) (No. 91-612), 1992 WL 687850 at *38.

50. See Keesling & Warren, *supra* note 17, at 52 (“[T]he acquisition of merchandise at lower costs or obtaining money at lower interest rates . . . are the most common examples of economic unity . . .”).

51. The Supreme Court struggled with exactly this issue in *ASARCO*, where the majority and the dissent disagreed over the extent to which a parent company’s ownership of a subsidiary affected the terms on which the parent could borrow money. *ASARCO Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 353 (1982) (O’Connor, J., dissenting).

Determining this degree of control requires a court to look not only at the legal power to control, but also at the actual influence being exerted, as demonstrated by evidence like the minutes of board meetings.⁵² This is not an easy thing to do. Cases from other areas of law that also deal with the question of *actual* control, for example, agency⁵³ or works made for hire,⁵⁴ point to how difficult a concept this is to measure.

Not only is the unitary business test fact-intensive, then, but the facts on which it hinges are often difficult or impossible to ascertain. This difficulty is exacerbated by the fact that all of the relevant information is in the hands of the businesses and not the state.⁵⁵ It is little wonder that states, in an attempt to avoid having to apply the test altogether, sometimes assess their taxes as if a business were unitary and leave it to the business to challenge the assessment.⁵⁶ This further adds to the unpredictability of the system and leads to expensive litigation when businesses choose to challenge the states' assessments.

B. The Unitary Business Test Is Arbitrary

The unitary business standard is binary: it divides the world into unitary and nonunitary businesses, and the Constitution in turn either allows or forbids the states to apportion the income of a business. And yet the level of integration and interdependence that exists in a given business is clearly a matter of degree. Because the various factors that contribute to a finding of unity have not been, and cannot be, meaningfully quantified or ranked, where to draw the line between unitary and nonunitary on this scale of integration is a matter of individual judgment.⁵⁷ Reasonable minds will disagree over the

52. See Wilson, *supra* note 34, at 90.

53. See, e.g., *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minn. 1981) (engaging in a multifaceted inquiry as to whether the control exerted by a creditor was so great as to create a principal-agent relationship).

54. See, e.g., *Easter Seal Soc'y for Crippled Children & Adults v. Playboy Enters.*, 815 F.2d 323, 334 (5th Cir. 1987) (criticizing the "actual control" test for determining whether a work was made for hire as fact-specific and unpredictable).

55. Although the burden of proving that a given business is unitary or nonunitary falls on the business, Miller, *supra* note 14, at 143, the business will easily and inevitably select those facts that support its desired result, effectively shifting the burden to the state if it wishes to prove a contrary result. See Wilson, *supra* note 34, at 89-91 (giving advice on how to manage document requests during unitary audits so as to arrive at the taxpayer's desired result).

56. Schoettle, *supra* note 34, at 313.

57. A report by the Comptroller General found that 40% of large corporations surveyed had filed protests to the application of the test. COMPTROLLER GEN., U.S. GOV'T ACCOUNTABILITY OFFICE, GGD-82-38, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON

extent to which a given factor—for instance, joint control—is present in a given business; reasonable minds will also disagree over how important this factor is for determining a business to be unitary in comparison to, say, common advertising and common use of intellectual property. An example from case law will help to illustrate how the unitary business analysis leads to ambiguous conclusions. This is also an opportunity to see the unitary business test in action and to render concrete for the reader the criticisms that this Note levels at it. The case is *ASARCO Inc. v. Idaho State Tax Commission*.⁵⁸

ASARCO was engaged in the business of mining and smelting nonferrous metals and operated a silver mine in Idaho. It was also the dominant shareholder of five foreign corporations from whom it received dividends and interest payments. The question before the Supreme Court was whether, in the case of each of these subsidiaries, the relationship between ASARCO and the subsidiary was sufficiently integrated that they together constituted a unitary business. Whether Idaho was constitutionally permitted to consider the dividends and interest payments in taxing ASARCO turned on this determination because the subsidiaries had no operations in Idaho. For brevity, I will consider only the subsidiary to which the Court dedicated most thorough treatment: Southern Peru Copper.⁵⁹

Southern Peru was a copper mining company located exclusively in Peru that exported and imported copper internationally. ASARCO owned 51.5% of the shares of Southern Peru, with the remainder being owned by three other mining companies.⁶⁰ Southern Peru sold 35% of its output to ASARCO and

WAYS AND MEANS OF THE U.S., KEY ISSUES AFFECTING STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME NEED RESOLVING 30 (1982); *see also* MULTISTATE TAX COMM'N, *supra* note 48, at 48 (“Obviously this unitary business combination approach involves the exercise of judgment on the part of the taxing authorities of each state taking that approach.”); Nemeth & Agee, *supra* note 3, at 247-48 (“A review of only a few of the numerous cases involved in the ‘unitary’ business concept clearly evidences the difficulties inherent in the subjective tests presently utilized.”).

58. 458 U.S. 307 (1982). At the same time it heard *ASARCO*, the Court heard another unitary business case, *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982), in which the Justices split six-three along the same lines. It should be noted that *ASARCO* deals specifically with the apportionment of investment income; its treatment of the definition of a unitary business is, however, of general applicability.
59. The differing depth of treatment was due partly to the fact that the majority felt that Southern Peru provided the closest case for unity among the subsidiaries, and also perhaps to the fact that the record below was most thoroughly developed with respect to Southern Peru. For instance, in the case of *ASARCO Mexicana*, another subsidiary, the record did not even reveal whether ASARCO and *ASARCO Mexicana* shared any common directors, *see ASARCO*, 458 U.S. at 324, which is a critical factor in the unitary business analysis.
60. *Id.* at 320.

another 20%-30% of its output to a shell company that had the same ownership structure as Southern Peru and that was run by ASARCO employees from New York.⁶¹ The metals received from Southern Peru were “substantial” to ASARCO’s operations, although there was testimony that ASARCO could have replaced them in short order. For a negotiated fee, ASARCO provided purchasing services and transport services for Southern Peru’s imports and exports, and also prepared its U.S. tax return. The lower court found that all of these transactions took place at market value.⁶²

In considering whether the relationship between ASARCO and Southern Peru was close enough to render the two unitary, the majority focused almost exclusively on the issue of control. It found that, although ASARCO’s majority stake would have allowed it to control Southern Peru, a management agreement gave ASARCO the right to appoint only six of the thirteen directors and the bylaws of Southern Peru provided that eight votes were needed for any resolution.⁶³ Furthermore, the assent of all four shareholders was needed to approve any amendment to the company’s articles or bylaws. In light of this, the Court concluded that the two corporations were “insufficiently connected to permit the two companies to be classified as a unitary business.”⁶⁴

In a vigorous dissent, Justice O’Connor, joined by Justices Blackmun and Rehnquist, began by criticizing the majority’s treatment of the control issue, noting that ASARCO was by far the largest shareholder of Southern Peru and that having six of the thirteen directors on the board gave it a unilateral veto power over the company’s actions. ASARCO also had direct control over the sale of more than half of Southern Peru’s output. In the dissent’s view, there was thus no doubt that ASARCO had substantial power over Southern Peru, and the majority erred by focusing too narrowly on whether this power was exerted “openly and aggressively . . . during the tax years in question.”⁶⁵ The dissent reasoned that the power of ASARCO necessarily influenced the transactions between the two entities even if there was no open and aggressive control.⁶⁶ Here, the elusive issue of actual control, discussed above, was on full display.

61. *Id.* at 321 & n.16.

62. *Id.*

63. *Id.* at 321-22.

64. *Id.* at 322. The Court’s reasoning with respect to M.I.M. and ASARCO Mexicana, two other subsidiaries in which ASARCO held 52.7% and 49% stakes, respectively, similarly focused on the lack of actual control exerted by ASARCO. *Id.* at 322-24.

65. *Id.* at 341 (O’Connor, J., dissenting).

66. *Id.* at 343 (noting that ASARCO’s “51.5% interest in Southern Peru Copper Corp. [was] an investment that evidently helped to assure ASARCO of supplies of unrefined copper, since 35% of the entire copper output of Southern Peru was sold to ASARCO”).

Even more important than the degree of control in the dissent's mind were two "business advantages"⁶⁷ that accrued to ASARCO because of its ownership of Southern Peru. First, the dissent noted that ASARCO's ownership would provide for greater stability of profits and for insurance against shock because the economic conditions affecting the mining business in the countries in which the subsidiaries operated "do not track those in the United States."⁶⁸ Second, the dissent found that ASARCO's ownership in Southern Peru ensured it a steady supply of raw materials so that it was insulated against "supply and demand imbalances."⁶⁹ Both of these factors—diversification and the possession of a captive supplier—were found to be material to the unitary business analysis in *Exxon Corp. v. Wisconsin Department of Revenue*,⁷⁰ a case that had been recently decided by the Court. The dissent argued that a true application of the unitary business test, as articulated in *Exxon* and in *Mobil*, required a finding of unity in ASARCO. Instead of looking holistically at the level of integration and interdependence between ASARCO and Southern Peru, the majority had introduced a new and "oversimplified test of active operational control."⁷¹

ASARCO is illustrative of a number of points. First, harking back to the previous Section, the case points up the fact-intensive nature of the unitary business inquiry. The majority and the dissent delved into many aspects of the two businesses, and this analysis constituted only a fraction of what the lower court had to consider.⁷²

Second, the majority and the dissent differed in their characterizations of the facts. That ASARCO elected six of the thirteen directors, for instance, was proof to the majority that ASARCO did not control Southern Peru, whereas for the dissent this indicated that ASARCO held a unilateral veto power and, therefore, was able to exercise control (recall that the vote of eight directors was required to pass any resolution).⁷³

67. *Id.*

68. *Id.* at 342. The Court specifically mentioned the conditions in Mexico and Australia, but there is no reason to think that it would not have reached a similar conclusion with respect to Peru.

69. *Id.* at 343 (quoting *Exxon Corp. v. Wis. Dep't of Revenue*, 447 U.S. 207, 225 (1980)).

70. 447 U.S. 207.

71. *ASARCO*, 458 U.S. at 343.

72. Consider, for instance, the valuation of the transactions between the two businesses, the difficulty of which was considered above, *supra* note 50 and accompanying text. The Supreme Court had only to take as true the lower court's conclusion that these took place at market prices.

73. *ASARCO*, 458 U.S. at 340 n.8.

Third, the majority and the dissent disagreed about how important the various factors that bear on the unitary analysis are in relation to one another, with the majority focusing on the issue of control and the dissent on the synergies and business advantages that accrued because of common ownership.

Lastly, the opinion as a whole points to the dubious competence of courts to undertake the kind of economic analysis required by the unitary business test in the first place. One might question, for instance, the dissent's assertion that mining conditions in the United States "do not track" those of the countries in which its subsidiaries operated, when the good in question—silver—is fungible and is sold at largely uniform prices on an international market.⁷⁴ And the majority was almost certainly wrong when it implied that ASARCO's ownership of its subsidiaries did not affect the financing of its own operations simply because ASARCO was never "required to utilize its stock as security for borrowing of working capital, acquiring stock or securities in other companies or to support any bond issues."⁷⁵ There was testimony that ASARCO's stake in the subsidiary M.I.M. alone was worth more than the entirety of ASARCO's own operations.⁷⁶ An asset of that magnitude undoubtedly influenced the terms on which ASARCO borrowed its working capital.⁷⁷ But, regardless of what one thinks of the merits of the Court's opinion in this particular case, economic analyses of this kind—of the correlation of international markets, and of the effect of ownership of an asset on financing terms—are likely not comfortable territory for most judges.⁷⁸

74. Of course, there will be conditions (for example, political or labor-related) that exist in these countries and not in the United States, but the most important effects on the international market for silver will be globally felt. So, at best, the Court's position is a gross overstatement of the lack of correlation between the conditions in the United States and in these other countries.

75. *ASARCO*, 458 U.S. at 325 n.21.

76. "Allegedly, Blackie's holdings in this project [M.I.M.] at market value exceed the market value of Blackie's own equities." Brief for Respondent on Reargument at 12, *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992) (No. 91-615), 1992 WL 525739, at *12 (citation omitted). "Blackie" was the code name for ASARCO. *Id.*

77. *See id.* at 11 (criticizing the court's opinion in *ASARCO* as "inconsistent with economic reality").

78. The lack of economic training among judges has been remarked on most frequently in the antitrust context. *See, e.g.*, Michael R. Baye & Joshua D. Wright, *Is Antitrust Too Complicated for Generalist Judges? The Impact of Economic Complexity and Judicial Training on Appeals*, 54 J.L. & ECON. 1 (2011); Memorandum from Jonathan B. Baker & M. Howard Morse, Co-Chairs, Am. Bar Ass'n Antitrust Section Econ. Evidence Task Force, to Officers and Council, Am. Bar Ass'n (Aug. 1, 2006), available at http://www.americanbar.org/content/dam/aba/administrative/antitrust_law/report_01_c_ii.pdf.

All of this should give us concern as to both the administrability and the predictability of the unitary business test. Imagine the general counsel to ASARCO before the litigation in question being asked whether operations in the United States and Peru would be treated as unitary by state tax administrators. Given the number of different ways in which the facts can be cast and weighed, and the uncertainty as to whether and to what extent they will even be unearthed, it would be very difficult to predict with any confidence at all. Although the Court repeated the unitary business test like a mantra throughout its opinion, it established no bright lines or concrete directions for future cases. Indeed the Court was at pains to point out that its decision was based on the particular facts before it.⁷⁹ How, for instance, would the Court have treated ASARCO if it elected eight instead of six of Southern Peru's directors, or if the transactions between the two were not at arm's length and at market value? Certainly the opinion provides no guidance. "[T]he Court's approach in *ASARCO*," writes a leading commentator, "seems to invite an endless stream of litigation over the requisite flow of goods, services, personnel and so forth, that are necessary to constitute a unitary business."⁸⁰ More recent cases have done nothing to clarify the standard,⁸¹ and the business community can thus look forward to a continuation of unpredictability in this area.

C. The States Differ in Their Application of the Unitary Business Test

The Supreme Court has acknowledged that "the unitary business concept . . . is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach."⁸² State courts have accordingly created many different formulations for the unitary business test.⁸³ The exact articulation of the test, however, is much less important than the application of the test in practice, for the same vague standards can be repeated by courts that apply the test restrictively as by those that apply it expansively.⁸⁴ But in practice, too, the

79. *ASARCO*, 458 U.S. at 329 n.24 ("[T]hese cases are decided on their facts . . .").

80. Hellerstein, *supra* note 43, at 173.

81. *See id.* at 183-84; Loram, *supra* note 2, at 603; *see also* James A. Mirage, Note, *A Solidification of the Unitary Business Principle: Allied-Signal, Inc. v. Director, Division of Taxation*, 46 *TAX LAW.* 541, 541 (1993) (noting with respect to *ASARCO* that "the Court failed to clarify significantly the rules concerning the unitary business principle").

82. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 167 (1983).

83. *See supra* note 41.

84. In fact, courts have done this. *See HELLERSTEIN & HELLERSTEIN*, *supra* note 45, ¶ 8.09[1].

states vary one from another, with courts in some states much more apt to find unity between operations than courts in others.⁸⁵

Admittedly, it is not clear whether this variation between states is any worse—from the standpoint of predictability and administrability—than the inevitable variation among individual judges and tax administrators that results from applying a test that is so arbitrary. It is thus not clear that variation among the states is an additional and independent criticism of the unitary business test. Nevertheless, a discussion of this variation is essential to understanding how the test is currently being applied, and also affords an opportunity to point out how inconsistent results between states—whether reached because the states differ in applying the test or simply because individual judges do—lead necessarily to either double taxation of corporate profits or no taxation at all.

Two leading commentators have undertaken an analysis of applications of the unitary business test and have found significant variation among the states.⁸⁶ Courts in some states, such as California, aggressively apply the test, finding unity even where there is no substantial flow of goods or services between the operations in question.⁸⁷ Other states have taken a much more restrictive approach, finding no unity in even the kinds of vertically integrated businesses that the Supreme Court has found to be unitary.⁸⁸ Still others have taken a kind of middle road, finding unity between operations if and only if there exists a substantial interdependence between the core operations of the business.⁸⁹ Of course, these are to some extent generalizations, and there is bound to be variation within a state, but they nevertheless indicate that courts

85. See *infra* notes 86-88 and accompanying text.

86. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 8.09[1].

87. See *id.* ¶ 8.09[3].

88. Compare *Tex. Co. v. Cooper*, 107 So. 2d 676, 682-83 (La. 1958) (holding that the use of separate accounting was required for an operation that drilled, refined, and sold oil in multiple states and maintained oil wells in Louisiana), with *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980) (finding the entirety of Mobil's drilling, refining, and retail operations unitary and requiring combined treatment even though the company maintained only retail operations in the taxing state in question). See generally HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 8.09[2].

89. The "core" operations would seem to exclude expenses that facilitate and are perhaps necessary to the business but do not constitute the business itself, such as financing, insurance, advertising, tax preparation, etc. See, e.g., *State ex rel. Ariz. Dep't of Revenue v. Talley Indus.*, 893 P.2d 17, 19 (Ariz. Ct. App. 1994) (finding no unity in spite of, *inter alia*, shared financing, office costs, insurance, and tax preparation). See generally HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 8.09[4].

in certain states generally apply the unitary business in a different manner from those in other states.

Variation among the states (or, indeed, variation among judges and tax administrators) means that businesses will be treated as unitary in some states and separate in others. In the case of Hercules, Inc., for instance, courts in multiple states were called on to determine whether Hercules and a company in which it had a significant ownership stake, Himont, were unitary. Hercules had sold its stake in Himont and reported the resulting capital gains only in its domicile state, Delaware.⁹⁰ In the litigation that arose in the other states in which Hercules operated, the question of unity was critical: if Hercules and its subsidiary were unitary, this income would have been taxable by all states in which Hercules operated; if the two were nonunitary, then the income would be taxable only by Delaware.⁹¹ Courts in Maryland, Illinois, and Minnesota found Hercules and Himont to be separate, while courts in Utah and Wisconsin found them to be unitary.⁹² There was also disagreement within the states, with superior courts reversing the lower courts' determinations of unity.⁹³ Whether this variation is attributable to differences among states or among judges is of little moment; what is important is that inconsistent results are being handed down in the treatment of identical businesses.

This inconsistency necessarily leads to either double taxation of corporate profits or "nowhere income" (i.e., income that is taxed by no state). Imagine, for instance, that the operations of a company in Maryland are more profitable than those in Utah. If Maryland finds the operations to be unitary but Utah does not, then some of the business's profits will be untaxed, for Maryland's inclusion of a less profitable arm will lower the revenue it gathers, while Utah's

90. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 8.09[5][a].

91. This is because income generated from the sale would have been classified as "nonbusiness" income, *see supra* note 16, and would have therefore been taxable only by the domicile state.

92. Hercules, Inc. v. Dep't of Revenue, 753 N.E.2d 418 (Ill. App. Ct. 2001); Appeal of Hercules, Inc., No. 1998-1666-DT (Kan. Bd. Tax App. Aug. 20, 1999); Hercules Inc. v. Comptroller of the Treasury, 716 A.2d 276 (Md. 1998); Hercules Inc. v. Comm'r of Revenue, 575 N.W.2d 111 (Minn. 1998); Hercules, Inc. v. Dep't of Revenue, No. 94-I-1494 (Wis. Tax App. Comm'n, Feb. 26, 1997); *see also* HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 8.09[5][a]; Scott D. Smith, *Whither Operational Function? Some Thoughts on MeadWestvaco*, 48 ST. TAX NOTES 951, 955-56 (2008).

93. Compare Hercules Inc. v. Comm'r of Revenue, Nos. 6532, 6533, 1997 WL 35467 (Minn. Tax Ct. Jan. 27, 1997) (finding the two to be unitary), *with* Hercules Inc. v. Comm'r of Revenue, 575 N.W.2d 111 (Minn. 1998) (finding the opposite). Compare Hercules, Inc. v. Comptroller of the Treasury, 699 A.2d 461, 463 (Md. App. Ct. 1997) (finding the two to be nonunitary), *with* Hercules Inc. v. Comptroller of the Treasury, 716 A.2d 276 (Md. 1998) (finding the opposite).

failure to include a more profitable arm will do the same.⁹⁴ Conversely, if Utah finds the operations to be unitary but Maryland does not, the business will be double-taxed.⁹⁵

Thus we have our final nail in the casket: in addition to being costly to administer and arbitrary, the unitary business test leads to inconsistency in the way that different states treat interstate businesses. This makes the landscape of state corporate taxation in the United States even more difficult to navigate and results in either double taxation of the corporate profits of interstate businesses or nowhere income.

III. THE COMMON CONTROL TEST

This Part proposes that the states abandon the unitary business test and use instead the Internal Revenue Code's common control test⁹⁶ to determine unity and to delineate the bounds of the entities whose profits they consider in taxing. The proposal was spurred by the following two observations. First, the unitary business test is unworkable not because we have yet to alight on the proper factors that contribute to economic integration and interdependence, but because the test requires courts and tax administrators to inquire into this integration and interdependence in the first place. For the reasons discussed in the preceding Part, any test that enters into this realm of economic substance will get bogged down in fact-intensive inquiries and subjective line drawing. There is a need to replace this economic analysis with a legal rule, rather than a standard, that will be clearer and more objective.

The second, more novel observation is that the federal government is already engaged in a delineation project of its own. The federal government must prevent businesses from fragmenting themselves into multiple entities so as to take advantage of lower tax brackets and multiply the number of certain tax benefits they would be entitled to. It does this by treating commonly controlled groups (defined according to actual and constructive chains of ownership) as single entities, denying them multiple benefits and aggregating

94. It is important to note that only one of these states actually loses revenue. In this example, if the business were unitary, then Utah would lose out (and Maryland's inclusion would be accurate), and if the business were separate, then Maryland would lose out (and Utah's exclusion would be accurate).

95. I do not consider a case in which the two arms are exactly equally profitable, for the likelihood of that is insignificant. Additionally, this example assumes that the states use the same factors for apportioning income. A difference in these factors will itself lead to either double taxation of corporate profits or no taxation at all.

96. As laid out in I.R.C. § 1563 (2006) and discussed at length in this Part.

their income. The problem encountered at the federal level (the spreading of income among many entities) bears a resemblance to the problem of profit shifting to lower-tax states, and the solution to both problems involves aggregating the income of the entities involved so as to render moot the profit shifting in question.⁹⁷

Beginning with this conceptual parallel between state and federal aggregation methods, Section III.A argues that the states should use the federal common control test, treating the commonly controlled group as determined for federal tax purposes as the taxable entity for state purposes. Section III.B lays out the principal benefits of using the common control test: savings through piggybacking; objectivity, simplicity, and uniformity; and greater stability of state revenues in times of local or regional economic volatility. Section III.C shows that the common control test is preferable to the “affiliated groups test,” which is used to determine eligibility for filing consolidated federal tax returns. Finally, Section III.D looks at the history of the common control test and finds that the federal government at one time used fact-intensive standards remarkably similar to the unitary business test to combat fragmentation. That these standards were eventually abandoned at the federal level buttresses the argument that states should follow suit and adopt an objective test.

A. An Outline of the Common Control Test

The Tax Reform Act of 1969⁹⁸ introduced the common control test into the Internal Revenue Code in response to widespread abuse of the graduated tax rate and of certain tax exemptions and credits through the use of multiple

-
97. Although fragmentation has become far less of a problem because the small businesses that were most likely to use the tactic now incorporate as LLCs or S-corporations, the common control test is still applied to all corporations. See IRS Form 1120, Schedules J & O (OMB No. 1545-0123) (2010). The test is also now used by cross-reference to combat a number of other avoidance strategies at the federal level and is therefore still a live area of rule refinement. The test, for instance, is used to define “employer” for purposes of ERISA. See I.R.C. § 414(b); PAUL J. SCHNEIDER & BRIAN M. PINHEIRO, *ERISA: A COMPREHENSIVE GUIDE* § 3.06(f) (3d ed. 2008). Much of the common control test is also incorporated by reference into the rules limiting the recognition of losses among related entities. See I.R.C. § 267(f).
98. Pub L. No. 91-172, 83 Stat. 487 (1969). The actual definition of controlled corporations was added to the Code earlier, but its application to deny the benefits of fragmentation did not come about until 1969, as is explained more fully below.

corporations—a tactic one might call “fragmentation.”⁹⁹ Here is how it works. The federal corporate income tax is graduated at low-income levels and is (more or less) progressive, with rates increasing as one moves into higher brackets.¹⁰⁰ This provides a strong incentive for companies to fragment their operations into multiple, smaller corporate entities so as to take advantage of the tax rates in the lowest brackets. If a company reports a \$100,000 profit, for instance, it will pay an overall rate of 22.25% today.¹⁰¹ But if the company simply uses a controlled subsidiary to split its profits, each corporation would report \$50,000, and the two corporations would pay in aggregate a rate of only 15%, a savings of \$7250, or 33% of the taxes paid. This fragmentation also multiplies the number of certain credits and exemptions that the business can claim—most notably, the surtax exemption, the accumulated earnings tax credit, and the alternative minimum tax (AMT) exemption.¹⁰² If the graduated tax rate is to be enforced, then, and the relevant exemptions and credits given only singularly to businesses, the federal government has to stop fragmentation.

The way the tax code accomplishes this is by treating “controlled groups of corporations”—corporations with common ownership of stock (explained more fully below)—as if they were a single entity for certain purposes. The controlled group is thus entitled to only one surtax exemption, and the income of the group is aggregated and taxed as if it had been earned by a single

99. See Peter K. Maier, *Use of Multiple Corporations Under the 1964 Revenue Act*, 42 TAXES 565, 566-68 (1964) (detailing the benefits that result from operating under multiple corporate entities); James E. Smith, *Multiple Corporation Transitional Period Tax Planning*, 52 TAXES 538, 554 (1974) (explaining how the Tax Reform Act of 1969 “severely limited the tax benefits associated with the multiple corporation”).

100. Tax rates are effectively not progressive, however, for businesses that earn large profits, because the benefits of lower brackets are “clawed back” with greater tax rates so that all of the business’s profits are taxed at the same average rate of 35%. Profits below a certain threshold are taxed at low marginal rates; profits above that threshold are taxed at a marginal rate above 35% until the average rate paid on all profits reaches 35%, whereupon the marginal rate drops to 35% on all income above that level. (This is somewhat simplified, as the actual scheme involves two levels of clawbacks.) See STEPHEN A. LIND ET AL., *FUNDAMENTALS OF CORPORATE TAXATION* 15 (7th ed. 2008). These high marginal rate clawbacks increase the benefits that are gained from fragmentation insofar as a corporation can “get under” the high clawback rates.

101. The company will be taxed 15% on the first \$50,000, 25% on the next \$25,000, and 34% on the last \$25,000. *Id.*

102. *Id.* at 628-29; Maier, *supra* note 99, at 566-68. For the AMT exemption, see IRS, Instructions for Schedule O (Form 1120), at 2, 4, 6, 8 (2011), available at <http://www.irs.gov/pub/irs-pdf/i1120so.pdf>.

entity.¹⁰³ This can be seen as a kind of federal combined reporting, and should remind us of the forced aggregation of income undertaken by the states. State and federal governments developed similar responses in part because they faced similar tax avoidance techniques. At the federal level, companies tried to fragment their operations so as to take advantage of the tax rate differences across brackets and multiply the exemptions and deductions to which they were entitled,¹⁰⁴ and, at the state level, companies tried to funnel profits into subsidiaries to take advantage of rate differences across states. The aim of both the states and of the federal government is to combine the income of these entities so as to render these tactics futile.

The federal common control test offers an objective and administrable alternative to the unitary business test. Instead of looking at the economic inner-workings of businesses, the test looks only at ownership and constructive ownership of stock. The Code defines three types of controlled groups. A “parent-subsidiary controlled group” consists of one or more chains of corporations connected through stock ownership where: (1) 80% or more of the value or voting power of the stock of each of the members is owned by one or more of the other members of the chain, and (2) the common parent owns 80% or more of the value or voting power of the stock of at least one corporation in the chain.¹⁰⁵ A “brother-sister controlled group” is a group of corporations 50% of whose stock (by vote or value) is owned by five or fewer individuals, estates, or trusts, taking into account such ownership only to the extent that it is identical with respect to each corporation in the group.¹⁰⁶ A “combined group” consists of three or more corporations, at least one of which is a common parent of a parent-subsidiary controlled group and a member of a brother-sister controlled group.¹⁰⁷

The taxable entity for state purposes could thus be delineated along these lines. Wherever the entities in question were a part of the same commonly controlled group as reported on their federal income tax returns,¹⁰⁸ the state would take into consideration the aggregate income of the group and tax a

103. See I.R.C. § 1563 (2006).

104. See S. REP. NO. 91-552, at 133-34 (1969) (explaining that the Tax Reform Act of 1969 was enacted to combat the use of multiple corporations to take advantage of tax provisions that were intended to benefit small businesses).

105. I.R.C. § 1563(a)(1). For helpful illustrations of all three types of groups, see 33A AM. JUR. 2D *Federal Taxation* ¶¶ 5604-06 (2011).

106. I.R.C. § 1563(a)(2), (f)(5).

107. *Id.* § 1563(a)(3).

108. See IRS Form 1120, U.S. Corporation Income Tax Return (OMB No. 1545-0123) (2010), available at <http://www.irs.gov/pub/irs-pdf/f1120.pdf>.

portion of it based on the percentage of sales, property, and/or payroll in the state.

The Code also includes a number of important anti-abuse provisions. For instance, it provides rules for the attribution of stock ownership (constructive ownership) in the case of call options, family members' ownership of stock, and attribution to major partners or shareholders of stock owned by the relevant partnership or corporation.¹⁰⁹ These rules are intended to combat taxpayer schemes designed to maintain control over a corporation while technically owning less than the required threshold of stock.¹¹⁰ Congress also defined the word "stock" in the statute so as to exclude non-voting securities (otherwise, taxpayers could sell non-voting securities to third-parties, while still maintaining total control over a corporation by virtue of their complete ownership of common voting stock).¹¹¹

B. Benefits of Adopting the Common Control Test

I have already alluded to some of the benefits of adopting the common control test, but I lay them out here for greater clarity. These benefits are principally: savings through piggybacking; objectivity, simplicity, and uniformity; and greater stability of state revenues in times of local or regional economic fluctuation.

As discussed in Section II.A, the states piggyback to a large extent on the administration of the federal income tax. It is important to note that, in state corporate taxation especially, piggybacking is the norm and independent state legislation and enforcement the exception.¹¹² This is true both with respect to the rules that govern the taxation of corporations generally, and with respect to particular assessments of taxes on individual corporations.¹¹³ Such "free riding" on the part of the states avoids wasteful duplication of labor and allows the states effectively to outsource the high costs of administering an income tax.

109. I.R.C. § 1563(d)-(e).

110. A taxpayer could, for instance, maintain effective control over a corporation by holding stock through family members or through a wholly-owned shell corporation. Alternatively, the taxpayer could own call options exercisable at a token price, which would be equivalent to ownership (i.e., a right to buy the stock in question for nothing).

111. *Id.* § 1563(c) (excluding, inter alia, preferred and treasury stock); see John W. Lee, *Section 482 and the Integrated Business Enterprise*, 57 VA. L. REV. 1376, 1385 (1971).

112. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 7.02 ("The outstanding characteristic of state corporate net income taxes is their broad conformity to the federal corporate income tax.").

113. *Id.*; see *supra* note 45 and accompanying text.

Under the current regime, the states must go it alone in applying the unitary business test because the IRS does not use the test in administering federal taxes. But if the states were to use the common control test as this Note suggests, they could piggyback on the efforts of the entire federal apparatus that interprets, refines, and applies this test; this apparatus includes congressional lawmaking, Treasury Department regulations, court decisions, and IRS auditing and enforcement. The IRS requires corporations to report whether they are part of a § 1563 controlled group and, if they are, to list all of the other corporations in the group.¹¹⁴ It would be trivially easy for the states to use this information to delineate the taxable entity. As taxpayers concoct new strategies to evade the common control test's ownership requirements, the federal apparatus counters with ever more refined rules.¹¹⁵ This back and forth results in a set of rules that is more effective in dealing with tax-planning techniques and also offers substantially greater certainty. The states are thus able to enlist the help of a formidable ally in this game of cat and mouse. Without this help, there is reason to believe that increasingly sophisticated state tax-planning divisions could—and do—outmaneuver the states.¹¹⁶

When it comes to piggybacking on federal tax policies, however, there is always a worry that the states will be “carried” in the wrong direction—that is, in a direction that serves federal but not state policies.¹¹⁷ But there is little danger of this with the common control test. Admittedly, the test would be applied to somewhat different problems in the federal and state contexts. However, once the test is put to these different uses, the states and the federal government have an identical interest in its application: stopping corporations from evading the stock ownership threshold while continuing to maintain control over affiliates and subsidiaries.

114. IRS Form 1120, Schedules J & O (OMB No. 1545-0123) (2010).

115. As noted above, the common control test is still critical for combating a number of other avoidance strategies at the federal level and is therefore still a live area of rule refinement. See *supra* note 97.

116. See Gary Cornia et al., *The Disappearing State Corporate Income Tax*, 58 NAT'L TAX J. 115 (2005); William F. Fox & LeAnn Luna, *State Corporate Tax Revenue Trends: Causes and Possible Solutions*, 55 NAT'L TAX J. 491, 501 (2002) (noting the erosion of state corporate tax revenue and that state and local tax planning is increasingly common, as evidenced by the growing size of state and local tax (“SALT”) groups at large public accounting firms).

117. This type of concern led many states to “decouple” from provisions in the Internal Revenue Code following the enactment of economic stimulus packages under the Reagan, Bush I, and Bush II administrations, which eroded the federal tax base. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 7.02; LeAnn Luna & Ann Boyd Watts, *Federal Tax Legislative Changes and State Conformity*, 47 ST. TAX NOTES 619, 619 (2008).

The common control test will also bring greater objectivity and simplicity to the administration of the state corporate income tax. As we have seen, the unitary business test involves a vast, detailed, and costly inquiry into the operations of businesses. Additionally, the test fails to offer meaningful guidance to those who would apply it, and therefore yields unpredictable results. The common control test, by contrast, rests principally on a simple and objective inquiry into actual and constructive stock ownership between groups of corporations.¹¹⁸

Additionally, adoption of the common control test would achieve uniformity across the states both because they would all use the same objective test and because they would piggyback on federal interpretations of the test and applications of the test to individual businesses. A commonly controlled group would have the same delineation for federal and state tax purposes. This stands in stark contrast to the current regime. As discussed above in Section I.C, the Supreme Court has sanctioned the use of different variations of the unitary business test in different states, and evidence suggests that the states do in fact apply the test differently. Discrepancies between state tax regimes lead to higher compliance costs for interstate businesses and make the United States a relatively less attractive place to do business. For this reason, uniformity has long been *the* central aim of the Multistate Tax Commission and the aim of countless scholarly proposals and congressional hearings in this area.¹¹⁹ Adoption of the common control test would take the United States a small step down this important path.¹²⁰

118. For a discussion of the special importance of objective rules in tax, see Lawrence G. Van Horn, *The Need for More Objective Tax Laws*, 51 TAXES 589 (1973).

119. See MULTISTATE TAX COMM'N UNIFORMITY COMM., CHARTER, available at <http://www.mtc.gov/Uniformity.aspx?id=484> (last visited Sept. 15, 2011) ("Central to the mission of the Multistate Tax Commission is the promotion and maintenance of uniformity in the States' taxation of interstate and foreign commerce. This was—and continues to be—the States' response to any call for congressional regulation and preemption of state taxation due to the diversity of state tax systems. Increased uniformity in state taxation eases the administrative burden placed on interstate and foreign commerce, and by forestalling the need for congressional action, preserves state tax sovereignty."); see also E. George Rudolph, *State Taxation of Interstate Businesses: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 174-75 (1970) (describing the Interstate Taxation Act, H.R. 11798, 89th Cong. (2d Sess. 1966), which proposed, inter alia, a uniform two-factor property/payroll apportionment formula, increased piggybacking on federal calculations of corporate income, and federal oversight of state corporate income taxation through the Treasury Department); Strauss, *supra* note 3 (noting the need for greater uniformity in this area and suggesting that state taxation be brought into greater conformity with federal taxation).

Finally, the common control test might increase a state's ability to weather local or regional economic fluctuations because it would decrease the correlation between a state's revenue and the profits of businesses *in that state*. A state's ability to counteract local economic downturns is severely circumscribed by the fact that its revenues (and thus its ability to boost its economy through spending) rise and fall with local economic conditions.¹²¹ Insofar as the common control test provides a more liberal standard for consolidating the profits of related entities,¹²² then the entities that states would tax under the test would be geographically wider-spread than under the narrower delineation of the unitary business test. State tax revenues would thus depend to a greater extent on the profitability of out-of-state operations and these revenues would be less tied to local and regional economic conditions. The common control test could therefore mitigate the procyclical nature of tax revenues and provide significant stability benefits to the states.

C. Why the Common Control Test Is Superior to the Affiliated Groups Test

Although no commentator that I am aware of has suggested that the states use the common control test, some have recommended that states use the federal "affiliated groups" standard, which is the standard of common ownership that a group of corporations must meet before it can file a

120. It is important to keep in mind that discrepancies between the apportionment factors used by states would still remain a source of nonuniformity even if the common control test were adopted. Discrepancies in apportionment formulae create the same problems of double taxation and nontaxation as does nonuniformity in delineation. For example, imagine a company operating in Alabama, which uses an equally weighted three-factor apportionment formula based on sales, property, and payroll, and in Georgia, which uses a single-factor sales formula. See *State Tax Apportionment*, MD. BUS. TAX REFORM COMM'N 1 (2010), available at http://btrc.maryland.gov/BITCsub/documents/State_Apportionment_Chart_7_19.pdf (surveying states' formulae). If the company has 75% of its sales in Georgia, 75% of its property in Alabama, and 50% of its payroll in each state, then Georgia will tax 75% of the company's profits, based solely on sales, and Alabama will tax 50% of the profits, based on all three factors. Thus, 25% of the company's profits will effectively be "double taxed." However, this is an entirely distinct problem and is not the province of this Note; there are many, many sources of nonuniformity in state corporate taxation, and this Note's ambition is to tackle just one of them.
121. This is both because tax revenues decline with the declining profitability of businesses and because tax expenditures follow the business cycle (thus increasing government subsidies at cycle peaks – the time at which these are least needed). See Yair J. Listokin, *The Income Tax Code at War with Fiscal Policy: Why Tax Scholars Can No Longer Ignore Macroeconomics*, 29 YALE J. ON REG. (forthcoming 2012), available at <http://ssrn.com/abstract=1372782>.
122. See *infra* notes 192-194 and accompanying text for a discussion of how the common control test might affect state tax revenues.

consolidated federal tax return.¹²³ In many ways, the affiliated groups test provides a more natural comparison because it would synchronize the standards of state combined reporting and federal consolidated reporting—the parallel means by which groups of related entities file at the state and federal levels.¹²⁴ Although the common control and affiliated groups tests are similar in their delineation of chains of ownership, the common control test is preferable for at least three reasons: (1) the common control test includes provisions that are designed to prevent corporations from evading its ownership thresholds; (2) the common control test’s ownership threshold is disjunctive (voting *or* value), whereas the affiliated groups test’s is conjunctive (voting *and* value), which makes the latter easier to evade; and (3) the common control test is mandatory and therefore provides determinations on which the states can piggyback for *all* corporations instead of just those that elect to file consolidated returns.

As has been discussed, the common control test is designed in part to prevent corporations from structuring their operations so that they can maintain control over subsidiaries but still fall outside of the test’s ownership threshold. It thus “forces” consolidation on groups. In contrast, the affiliated groups test does not include any anti-abuse measures to prevent corporations from avoiding its ownership standards. This is because consolidated reporting is elective; corporations can simply elect not to file a consolidated return and thereby avoid the test entirely. Thus, the affiliated groups test does not include the constructive ownership rules discussed in Section III.A,¹²⁵ and is open to all of the abusive schemes that those provisions were designed to target. If the states were to use the affiliated groups test, groups of corporations could easily structure their ownership so as to maintain control over subsidiaries while evading consolidation (by, for instance, effectively controlling all of the stock

123. See, e.g., Nemeth & Agee, *supra* note 3, at 248; Strauss, *supra* note 3, at 73. Some states, like Florida, do in fact allow combined reporting wherever a group of entities files a consolidated federal return. See FLA. STAT. ANN. § 220.131 (West 2005) (allowing for the filing of a combined state tax return in those cases where a federal consolidated return has been filed, provided that the group is identical).

124. State combined reporting has already borrowed much from the administration of the federal consolidated return, including rules for eliminating intercorporate transactions and dividends. See Leonard R. Powers, *Combined Reporting: Myths and Illusions*, 12 J. ST. TAX’N 22, 30 (1993).

125. See I.R.C. § 1504(a)(1) (2006) (requiring that the common parent own enough stock to meet the requirements of the test and that it own this stock “directly”). On the differences between the common control test and the affiliated groups test generally, see HOFFMAN ET AL., CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS § 8-10 to -13 (2008).

of a subsidiary through call options to buy shares for a penny). This alone is enough to make the affiliated groups test infeasible.

Additionally, the affiliated group test's stock ownership threshold for consolidation is 80% on a voting *and* value basis, whereas the common control test is disjunctive (voting *or* value).¹²⁶ The conjunctive test is less strict because it allows businesses to evade the ownership requirement on either a voting or value basis. This would open the door to a variety of evasion schemes. Consider the following example. A parent corporation sets up a subsidiary in a no-tax state with two classes of stock, one of which is entitled to vote but represents almost no equity and is entitled to no dividends. A minority shareholder holds 20.1% of this voting stock, and the parent owns the remaining 79.9% and has a call option on 0.2% of the voting stock. The parent then funnels profits to the subsidiary, exercises its call option, and takes the profits back in the form of dividends or else by liquidating the subsidiary. (The call option is necessary because the parent would have to pay a federal tax on the dividend or liquidating distribution if it owned less than 80% of the vote *or* value of the subsidiary).¹²⁷ This scheme would be unavailable under the common control test because the parent would also have to own less than 80% of the value of shares in order to avoid consolidation, and the 20% minority shareholder(s) would be entitled to a pro rata distribution of the dividend under Delaware corporate law.¹²⁸ (The call option would also be considered constructive ownership under the common control test.)

Lastly, the common control test is applied to all corporations, the result being that the states can always piggyback on federal determinations of whether to treat groups of corporations as single entities. In contrast, many corporations do not file consolidated returns,¹²⁹ and therefore the opportunity to piggyback on federal determinations is accordingly limited. For all those corporations not filing consolidated returns, the states would have to inquire independently into whether the corporations nonetheless would qualify under the affiliated groups test—an additional burden on both the states and corporations.

126. Compare I.R.C. § 1504(a)(2) (affiliated groups test), with I.R.C. § 1563(a)(1) (common control test).

127. The parent receives only an 80% deduction if it owns less than 80% of the subsidiary. *Id.* § 243. Loss of a 20% deduction is effectively a tax of 7% if the parent's income is taxed at 35%. On the liquidation option, the parent must pay a capital gains tax if it owns less than 80% of the vote or value of the subsidiary. *Id.* § 332(b)(1).

128. See *infra* note 173 and accompanying text.

129. See IRS, 2007 STATISTICS OF INCOME, at 159 tbl.18, 160 tbl.19 (2007), available at <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html>.

As for other proposed formal tests that involve ownership thresholds,¹³⁰ these accomplish the same aims as the common control test (objectivity, uniformity, and administrability), but without the significant added benefits of piggybacking on the administration of the federal income tax and incorporating the refinements and anti-abuse provisions of the federal test. The common control test is therefore demonstrably superior to these formal alternatives.

D. Predecessors of the Common Control Test

The common control test was not the federal government's first attempt to combat fragmentation. Prior to 1969, the government used fact-intensive and subjective standards remarkably similar to the unitary business test to treat fragmented entities in a consolidated manner. That the federal government found these standards ineffectual and eventually replaced them with an ownership-based, objective test buttresses this Note's argument that the states should do the same.

Prior to the common control test, the IRS primarily used Code sections 269 and 482 (and their predecessors) to combat fragmentation.¹³¹ Section 269 allows the Commissioner to deny deductions and credits arising from corporate acquisitions where the acquisition was made for purposes of tax "evasion or avoidance" (in contrast to acquisitions made for valid business purposes).¹³² Section 269 has been construed also to apply to the tax benefits that arise from the *formation* of corporations, and thus to the formation of the kinds of multi-corporate structures that can be used to reap the benefits of fragmentation.¹³³ The taxpayer can, however, demonstrate a valid business purpose for using multiple corporations by showing that the corporations operate as separate functional units.¹³⁴ If this is the case, the separate incorporation will be respected. But if the entities operate as an integrated whole, they will be treated in aggregate.¹³⁵ Distinguishing the integrated from

130. See *supra* sources cited note 3.

131. See generally Maier, *supra* note 99 (documenting the Service's use of I.R.C. §§ 269 and 482 to combat the use of fragmentation).

132. I.R.C. § 269(a)(2) (2006).

133. See *James Realty Co. v. United States*, 280 F.2d 394 (8th Cir. 1960); Maier, *supra* note 99, at 572.

134. See Maier, *supra* note 99, at 573-75.

135. This will be the case provided that the taxpayer does not prove some other valid business purpose – for example, limitation of liability. See *id.* at 575.

the independent requires the same fact-intensive analysis that was criticized above in Section II.A. Section 269 is also deficient in that it hinges on the subjective determination of a taxpayer's purpose in using multiple corporations.¹³⁶

Similarly, under § 482 the Commissioner can allocate income, deductions, and credits among commonly owned or controlled entities if she deems this necessary to accurately reflect the taxpayer's income.¹³⁷ Where entities operate as an integrated whole, some courts allocated all of their income to the managing entity so as to achieve a de facto consolidation and to deny the benefits of fragmentation. In those cases, the determination of whether the entities were so integrated as to require consolidation was almost identical to the unitary business test. In *Hamburgers York Road, Inc. v. Commissioner*,¹³⁸ for example, the Commissioner considered the interlinked operations of two commonly controlled stores, delving into whether the two had common shareholders, advertising, compensation schemes, display techniques, purchasing, accounting, etc.¹³⁹ Finding that the "taxpayers carried on a business under arrangements where the segments of the business are so interwoven that reconstruction to comply with the arm's length standard is probably not realistic nor feasible," the Seventh Circuit upheld the de facto consolidation of the group.¹⁴⁰

Recognizing the deficiencies inherent in these cumbersome and subjective approaches, the House of Representatives in 1951 recommended denying the

136. See Reinhold Groh, *Multiple Entities*, 40 TAXES 486, 490-97 (1962) ("[W]herever the taxpayer cannot prove that the major purpose of forming a multiple entity has good business purpose, the multiple arrangement will be suspected and may lead to litigation . . ."); Maier, *supra* note 99, at 571-76.

137. This common ownership and control is not defined by the statute. See I.R.C. § 482. Treasury regulations at the time § 482 was being used to combat multiple incorporation, however, defined control to be "any kind of control . . . whether legally enforceable, and however exercisable or exercised. It is the reality of control which is decisive, not its form or the mode of its exercise." *Charles Town, Inc. v. Comm'r*, 372 F.2d 415, 419 (4th Cir. 1967) (quoting Treas. Reg. § 1.482-1(a)(3) (1962)). This should remind the reader of the unitary business test's inquiry into "actual control." See *supra* note 52 and accompanying text.

138. 41 T.C. 821 (1964).

139. *Id.*; see also *Marc's Big Boy Prospect, Inc. v. Comm'r*, 52 T.C. 1073 (1969), *aff'd sub nom.* *Wis. Big Boy Corp. v. Comm'r*, 452 F.2d 137 (7th Cir. 1971) (finding, after a protracted analysis of the workings of the business in question, that its constituent entities functioned as a single integrated business enterprise and therefore upholding the Commissioner's de facto consolidation). *But see Comm'r v. Chelsea Prods.*, 197 F.2d 620, 623 (3d Cir. 1952) (holding that the former § 45, the predecessor of § 482, did not allow the Commissioner to consolidate the income of related corporations).

140. *Wis. Big Boy*, 452 F.2d at 141.

surtax exemption (one of the most valuable benefits that could be multiplied through fragmentation) to multiple corporations operating as a unit.¹⁴¹ The Senate rejected the proposal on the grounds that valid business purposes existed for the use of multiple corporations.¹⁴² A compromise was reached in § 1562 (now repealed), which imposed a 6% penalty on the first \$25,000 in profit of controlled corporations.¹⁴³ This penalty, it was thought, would greatly diminish the benefits otherwise obtained through multiple surtax exemptions created through fragmentation.¹⁴⁴ This section was a vast improvement on §§ 269 and 482 in that it used the ownership-based common control test discussed above to define a controlled group of corporations, but its penalty was too meager to discourage fragmentation, and courts often held for the taxpayer upon a showing of a valid business purpose.¹⁴⁵ Finally, in 1969, Congress, through § 1561, denied flat out the benefits of fragmentation to controlled corporations (again defined according to the ownership-based common control test), regardless of whether separate incorporation was used for a business purpose.¹⁴⁶ Although §§ 269 and 482 are still a part of the tax code, § 1561, with its clear and objective rules, quickly came to predominate as the most effective vehicle for denying the benefits of fragmentation and continues to be the Service's tool of choice today.¹⁴⁷

At the federal level, then, tax authorities, courts, and Congress struggled to devise a tool to prevent businesses from reaping the tax benefits of fragmentation. Sections 269 and 482, with their fact-intensive analysis of functional integration and business purpose, proved inadequate to the task. It was not until a clear, ownership-based rule was adopted to delineate the bounds of a controlled group that fragmentation was adequately addressed. This is just one example of a pattern that has repeated itself throughout the history of taxation in the United States: the abandonment of vague and manipulable standards in favor of clearer—though potentially less accurate—

141. H.R. REP. NO. 82-586, at 23-24 (1951).

142. S. REP. NO. 82-781, at 67-69 (1951).

143. I.R.C. § 1562 (1964) (repealed 1969).

144. *Id.*

145. See Lee, *supra* note 111, at 1380; Maier, *supra* note 99, at 579-80.

146. S. REP. NO. 91-552, at 133-34 (1969).

147. See 1 MERTENS LAW OF FEDERAL INCOME TAXATION § 2:53 (2011) (noting that §§ 1561 and 1563 are the preferred tool for “attacking the corporate benefits of graduated tax brackets”); Joseph R. Oliver, *Avoiding Controlled Group Status: Growing Motivations and Challenges*, 68 TAXES 70, 71 (1990) (“Section 1563 and its extensions have virtually taken the place of Sections 269 and 482 with respect to domestic corporations in recent years . . .”).

rules.¹⁴⁸ As we have seen, the states, too, have struggled with a fact-intensive and subjective standard, the unitary business test, to delineate the bounds of the entity that they wish to tax. It is time that the states make the same transition from these standards to an objective, ownership-based rule.

IV. COUNTERARGUMENTS

This Part considers the three most significant arguments against adopting the common control test. They are: first, that the common control test will lead to extraterritorial taxation because states will consider profits that are not sufficiently connected to activities in the taxing state to satisfy the Fourteenth Amendment's Due Process Clause; second, that the formalism of the common control test will invite manipulation because the test's ownership standard is a fixed target around which tax planners will be able to structure; and, third, that states will be unwilling to adopt the common control test unilaterally, which would greatly diminish the test's chance of being adopted at all.

A. The Constitutionality of the Common Control Test

Perhaps the most serious objection to the use of the common control test is that it would result in extraterritorial taxation in violation of the Due Process Clause. If we return to the example of the 100% commonly-owned orange grove in California and grocery store in Connecticut, it would likely be unconstitutional for Connecticut to consider the profits of the orange grove in levying a tax on the grocer if there were no integration or synergy between that business and business activities conducted in Connecticut (as would be the result under the common control test's 80% threshold).¹⁴⁹ The wisdom in the field has therefore been that a formal test would raise serious Due Process concerns.¹⁵⁰ Though the Court has never ruled directly on the constitutionality

148. See David Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999) (cataloguing multiple examples of this trend).

149. This would be a quintessential example of the parent-subsidiary chain described *supra* note 105 and accompanying text.

150. See, e.g., John L. Coalson, Jr. & Michael T. Petrik, *Consolidated or Combined Returns and Alternative Corporate Reporting Methods: A Georgia Perspective*, 8 J. ST. TAX'N 133, 134-35 (1989) (assuming that states cannot constitutionally require consolidated returns); Hellerstein & McLure, *supra* note 4, at 203 (indicating that states are constitutionally mandated to aggregate entities according to economic integration); E. George Rudolph, *State Taxation of Interstate Businesses: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 193 (1970) (asserting that a federal bill allowing states to

of a formal test, it was hostile to the possibility when it was raised in oral argument in *Allied-Signal*¹⁵¹ and has held that the unitary business test's substantive economic analysis is the "linchpin of apportionability"¹⁵²—that is, an essential prerequisite to any constitutionally permissible scheme of apportionment.

This Section offers a partial defense of formal tests by arguing, first, that an ownership-based standard could function as a proxy for the presence of synergy and therefore that formal tests would not result in the aggregation of the profits of completely unconnected entities; and, second, by pushing us to reconsider the wisdom of Supreme Court case law that would require the states to administer a burdensome and arbitrary test when there are fairer and more practicable alternatives.

The constitutional objection hinges entirely on the possibility that the profits of commonly controlled entities would be swept into the taxing power of a state even though they lack the economic integration and synergy with activities in that state to justify extension of its taxing power. But there is reason to believe that this will rarely be the case.

As Justice Kennedy recognized at oral argument in *Allied-Signal*,¹⁵³ the mere fact of common control creates certain beneficial synergies. A few are listed here. First, common ownership can lead to lower costs of capital (the grocer, for instance, might receive more favorable terms on goods extended on credit because of its affiliation with the grove). Second, common ownership smoothes the aggregate income of the businesses, so long as their returns are not perfectly correlated. Third and relatedly, there is an insurance function to common ownership because the possibility of drawing resources from one business allows the other to engage in otherwise prohibitively risky (but nonetheless expected-value-positive) projects. And fourth, tax-related benefits accrue from common ownership for groups that file consolidated federal income tax returns because losses can be shared among members of the group and earnings can be shifted without having to pay dividend taxes on the transfers.¹⁵⁴

delineate the taxable entity based solely on ownership raised the question of "whether Congress . . . can override due process limitations").

151. Transcript of Oral Argument at 38-42, *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (Mar. 4, 1992) (No. 91-615), 1992 WL 687826, at *38-42.

152. *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 439 (1980).

153. See Transcript of Oral Argument at 10-15, *Allied-Signal*, 504 U.S. 768.

154. For instance, a conglomerate could shift earnings from low-growth, high-cash-flow lines of business to high-growth, low-cash-flow lines of businesses without having to pay taxes on

Beyond these general benefits, there will be other specific synergies—whether from shared management, or intellectual property, or advertising—that justify common control in particular instances. There is a vigorous market for corporate control and for ownership of assets and businesses.¹⁵⁵ This market, like any market, functions to allocate the assets into the hands in which they are most highly valued, and the principal determinant of this *relative* value is synergy that results from acquisition.¹⁵⁶ For instance, if the owner of a lemon grove valued ownership of the orange grove in California more highly than did its current owner because of shared “citrus know-how,” the owner of the lemon grove would buy the orange grove. Of course, there are many caveats to this simplistic example—not the least of which is the presence of transaction costs—but the overall point is that the market for control *tends* to place businesses under an umbrella of ownership that results in synergy.

Because commonly controlled entities incur certain tax disadvantages at the federal level vis-à-vis separate entities, the benefits that accrue from common ownership can be expected to outweigh these disadvantages.¹⁵⁷ Otherwise, the entities would likely not be commonly controlled. Recall that the Internal Revenue Code denies multiple tax benefits to controlled groups and aggregates their income to prohibit multiple use of the lower tax brackets. Thus, common control comes at a price; two separate entities would make more money after tax, *ceteris paribus*, than they would if commonly controlled. These disadvantages at the federal level will only be incurred where the benefits of common ownership are sufficiently large as to outweigh them.¹⁵⁸

the transfer. If the two lines of business were not commonly owned, however, the recipient of this transfer would owe a dividends tax. See I.R.C. § 243 (2006).

155. See, e.g., Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988) (giving a broad overview of the market for corporate control).
156. See, e.g., Erik Devos, Palani-Rajan Kadapakkam & Srinivasan Krishnamurthy, *How Do Mergers Create Value? A Comparison of Taxes, Market Power, and Efficiency Improvements as Explanations for Synergies*, 22 REV. FIN. STUD. 1179 (2009) (finding the average synergy gains in a broad sample of large mergers to be 10.03% of the combined equity value of the merging firms, and that operating synergies, rather than tax savings or market power, accounted for the large bulk of this).
157. This analysis is complicated somewhat by the fact that firms and their managers cannot always be expected to adopt maximally efficient corporate structures. Managers, for instance, have a well-documented propensity to grow businesses into unwieldy and inefficient conglomerates so as to increase private benefits, which are correlated with the size of the assets under control. See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 72 (2003) (noting empire building as an agency cost).
158. The disadvantages of common control are much more pronounced for smaller businesses. This is both because the relative value of the tax benefits at issue (for example, the surtax

To quell remaining concerns as to the constitutionality of the common control test, states could include relief provisions in their statutes allowing taxpayers to challenge the application of the test where they believe extraterritorial value has been taxed (i.e., where the taxing state lacks a sufficient connection to the profits at issue). Under such a scheme, aggregation of the income of commonly controlled entities could be seen as a mere rebuttable presumption—one that is justified for all of the reasons that synergies can reasonably be presumed to exist in commonly controlled entities.

Admittedly, the use of these relief provisions would throw us back into the fact-intensive mess that characterizes the unitary business test, but it would do so in far fewer instances. For the reasons given above, it will rarely be the case that the common control test will aggregate entities with little integration or synergy. Most states already have similar relief provisions to deal with instances where formulary apportionment does not fairly represent the extent of business activity in the state;¹⁵⁹ these could be used as models for the common control test's relief provisions.

* * *

Although this Section has struck a confident tone as to the constitutionality of the common control test, it must be admitted that Supreme Court jurisprudence in this area has clung ardently to the unitary business test. But if this test is indeed arbitrary and unadministrable, and if the common control test offers a path out of the current quagmire, it may be worth briefly taking a step back to reconsider the wisdom of a doctrine that would bind the states in such an impractical manner.

State taxation of interstate businesses is, and will always be, an imprecise undertaking. The tools that have been developed, including apportionment and combined reporting, are blunt instruments designed to allow the states to raise some revenue from businesses in a way that is both administrable and somewhat proportionate to the scope of a business's activity in the taxing state. Recognizing the need for approximation in this field, the Supreme Court has in many instances provided the states with broad latitude to determine how best

exemption) decreases as the profits of a company increase, and also because the profits of large corporations are all taxed at the same rate, LIND ET AL., *supra* note 100, at 15, so that the combination of two such corporations would not result in the loss of multiple use of lower brackets.

159. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE AND LOCAL TAXATION: CASES AND MATERIALS*, 651-52 (2001). These provisions are modeled after section 18 of the Uniform Division of Income for Tax Purposes Act (UDITPA).

to levy a tax on interstate businesses. It has, for instance, sanctioned the use of sales as the sole proxy for determining what portion of an interstate business's activity is allocable to a state.¹⁶⁰ This single-factor apportionment is a very rough estimate of the source of an interstate business's income, to put it mildly. The watchword in this area has thus been pragmatism. Indeed, the unitary business test itself was blessed by the Supreme Court in upholding California's pragmatic innovations in taxing interstate business;¹⁶¹ it is ironic, then, that the blessing has now ossified into an impracticable constitutional requirement.

Much confusion has been created by applying the term "extraterritorial taxation" to this context. We must remember that states do not simply reach out and tax profits when they include entities operating outside of their boundaries; they merely consider that income and those operations in determining what portion of the aggregate income is properly assignable to the state. Connecticut does not tax the profits of the grove, but rather considers those profits in taxing the grocer. The size of the pie increases, but the state's slice decreases, resulting in either an increase or a decrease in revenue.¹⁶²

In light of this framework, the question to be asked is whether requiring groups of commonly controlled businesses to pay a tax on their income *in proportion to their activity in states* (as determined by sales, property, and/or payroll) is so outrageous as to offend the Due Process Clause's mandate of "fundamental fairness."¹⁶³ It is difficult to make robust arguments as to what "fairness" in the commercial context requires, but this scheme would seem to be the only administrable way for multiple jurisdictions to tax businesses that span their boundaries (so much, at least, has been concluded by most scholars considering a consolidated system for the EU).¹⁶⁴ It is instructive to note that Congress has before considered bills that would define the taxable entity according to ownership,¹⁶⁵ and that the EU Commission has recently recommended a consolidated-tax-base approach that would delineate the taxable entity on the basis of ownership and voting.¹⁶⁶ All of this should

160. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

161. See *supra* note 26 and accompanying text.

162. For an exposition of this point, see *supra* note 22 and accompanying text.

163. *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992).

164. See *supra* note 4.

165. Interstate Taxation Act, H.R. 11798, 89th Cong. § 205(c) (2d Sess. 1965).

166. However, the proposal at the moment would be voluntary. *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base*, at 13, 37-38, COM (2011) 121/4, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf.

constitute common-sense evidence that aggregation of profits on the basis of common ownership is not grossly unfair.

Of course, adoption of the common control test will lead to some dislocation in the short run, and the settled expectations of businesses will be temporarily upset. But the new landscape will be far clearer. Commonly controlled groups will know with certainty that they will be taxed in proportion to their activities in states, and there will *never* be double taxation or nowhere income as a result of differences in delineation. This Note's proposal must be measured in relation to the status quo's dismal alternative.

B. Tax Avoidance Opportunities Under the Common Control Test

Because the common control test focuses exclusively on ownership, there is a worry that its formalistic standards will provide fixed targets for sophisticated companies to plan around, and that it might therefore encourage tax avoidance strategies that a more substantive analysis would prevent. Specifically, the common control test might lead businesses to: (a) structure their affairs so as to fall below ownership thresholds while maintaining control over subsidiaries and using these subsidiaries to funnel profits to low-tax states,¹⁶⁷ (b) acquire controlling stakes in unrelated companies for the purpose of including them in the control group and lowering overall tax liability, or (c) divest control of companies for the purpose of lowering overall tax liability. The first of these is unlikely to occur because it would be unprofitable as a strategy; the second leads to ambiguous welfare consequences and therefore tells us nothing about whether the common control test should be adopted; and the third, although a source of inefficiency, is equally problematic under the status quo and cannot therefore be considered an argument against the common control test.

It is important to note at the outset that the formalism that worries critics is not unique to the common control test. Most states currently use an ownership threshold of between 50% and 80% as a separate requirement from the unitary business test.¹⁶⁸ That is, if a state wishes to tax an entity, that entity must be

167. See, e.g., *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 790 (1992) (O'Connor, J., dissenting) ("Were we to adopt a rule allowing taxation to depend upon corporate identity alone, as New Jersey suggests, the entire due process inquiry would become fictional, as the identities of corporations would fracture in a corporate shell game to avoid taxation."); Fox & Luna, *supra* note 116, at 506 ("[A]n arbitrary ownership requirement for combination, such as an 80% rule, may still allow companies to avoid taxes by establishing 79% ownership or some other manipulation of the intent.").

168. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 8.11.

connected to an entity doing business in the taxing state through both common ownership *and* the integration and interdependence required by the unitary business test. Since formal ownership is thus a required element of taxability, many of the tax-planning opportunities that allegedly are afforded by a formal, ownership-based standard are also present under the current regime.

Which of the two tests is, on balance, easier to evade is open to dispute (as are the social welfare consequences of making taxes easier to evade).¹⁶⁹ On the one hand, the unitary business test's ownership threshold in some states is lower than 80%, which makes the test more difficult to evade. On the other hand, the unitary business test is conjunctive and thus allows a business to escape consolidation if it evades either of the test's two prongs. Moreover, the unitary business test lacks many of the enforcement-related advantages of the common control test. As already discussed, the common control test includes far more refined rules to prevent manipulation than do the state thresholds currently in use,¹⁷⁰ and adoption of the common control test would allow the states to enlist the federal government as a partner in policing manipulation.¹⁷¹ It is therefore unclear which of the two tests is easier to evade.

With that clarification made, we turn to the first tax avoidance concern raised by the common control test: that parent companies will take 79.9% stakes in subsidiaries located in low-tax states so as to maintain control over these subsidiaries while avoiding being placed in the same common control group. The parent company, firmly in control of the subsidiary, would then be free to funnel its profits—by manipulating transfer prices or otherwise—into that subsidiary, and would not have to worry about these profits being aggregated with its own profits. The funneled profits would thus be taxed only by the low-tax state and could later be paid out as dividends. A consequence of

169. Even if it were definitively established that one test were easier to evade than the other, the welfare implications of this conclusion would be ambiguous. Suppose that the unitary business test were more easily evaded than the common control test. If a state adopted the common control test, then we might expect there to be a decrease in the amount of tax evasion, but we might also expect some firms (those that reap the greatest benefits from evasion) to increase their investment in tax evasion so as to evade the new, more restrictive test. Since tax avoidance is zero-sum from a welfare perspective (i.e., it involves merely a redistribution, and not a diminution, in welfare), whereas the costs incurred through investments in tax evasion are deadweight losses, there is a plausible social-welfare case to be made for adopting the test that is *easier* to evade. For a general discussion of this counterintuitive point, see Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 279-82 (2002).

170. See *supra* note 109 and accompanying text.

171. See *supra* notes 114-116 and accompanying text.

this strategy, however, is that the funneled profits must be shared with the 20% or greater unrelated minority shareholder(s) of the subsidiary. While some of this loss could be recouped through the sale of the minority stake, there is reason to think that this stake could only be sold at a significant discount because the minority shareholder would find itself in a high-agency-cost situation (i.e., with very little control and with a divergence between its own interests and the interests of the majority-shareholder-dominated management). Transfer of profits from parent to subsidiary would be entirely at the discretion of the parent, and the minority shareholder would thus have little guarantee of a stream of dividends and would discount its purchase price to reflect this risk.¹⁷² Nor could the entirety of the profits be shifted back to the parent corporation, because that would be a non-pro rata dividend: a clear breach of fiduciary duty to the minority shareholders of the subsidiary on the part of its board of directors and likely also a breach on the part of the dominant shareholder.¹⁷³ Moreover, this strategy would force the parent to pay a significant federal tax (approximately 5.6%) on the received profits because the parent is entitled to a full dividends received deduction (i.e., would not pay any tax) on this transfer only if it owns 80% or more of the subsidiary.¹⁷⁴ Evading state corporate taxes at rates of between 5% and 10%¹⁷⁵ (which taxes are deductible at the federal level and therefore of lesser effective magnitude) will rarely, if ever, outweigh the haircut on profits that results from having minority shareholders in the subsidiary, the loss of the full dividends received deduction, and the transaction costs associated with structuring this deal. One can expect, therefore, that this strategy will rarely be pursued.

172. Technically, *all* of the loss could be recouped by selling the minority stake for the present discounted value of the future stream of all dividend payments to the minority shareholder. But it would be impossible to contract so that the minority shareholder would be guaranteed these payments. A contract agreeing to funnel a certain portion of the parent's earnings to the sub would be dispositive evidence that the arrangement was one designed to evade taxes and would spoil the entire scheme. Perhaps it is the author's lack of imagination, but the vulnerability on the part of the minority shareholder here seems impossible to eliminate through contract.

173. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (finding that the majority shareholder breached its fiduciary duty to 3% minority shareholders by failing to pursue a breach of contract remedy against the parent corporation); WILLIAM A. KLEIN ET AL., *BUSINESS ASSOCIATIONS* 357 (7th ed. 2009).

174. I.R.C. § 243 (2006). Loss of a 20% deduction on the 80% of profits being shifted back to the parent is effectively a tax of 5.6% if the parent's income is taxed at 35%.

175. FED'N OF TAX ADM'RS, *RANGE OF STATE CORPORATE INCOME TAXES* (Feb. 2011), available at http://www.taxadmin.org/fta/rate/corp_inc.pdf.

A second tax-planning concern raised by the common control test is that the test would allow companies to acquire unrelated entities in other states so as to lower their overall tax liability. Recall that a business's aggregate tax liability will decrease if less profitable entities in low-tax states are placed in the same common control group as more profitable entities in high-tax states (this is because some of the aggregate profits are effectively shifted from the low-tax to the high-tax state).¹⁷⁶ "Profitability" for purposes of this discussion means the ratio of profits to whatever apportionment factors are used by the state in question (property, payroll, and/or sales).¹⁷⁷ There is, therefore, some room for sophisticated companies to lower their tax liabilities by creating tax-favorable common control groups through acquisitions.

Consider the case of a corporation in Iowa, a state with a 12% tax on corporate income over \$250,000 and an apportionment formula that is based solely on sales.¹⁷⁸ As an example, we can use Principal Financial Group, a Fortune 500 company based in Des Moines. If Iowa adopted the common control test, Principal Financial would want to look for acquisition targets in a low-tax state such as Colorado, which has a 4.6% flat tax on corporate income.¹⁷⁹ In particular, Principal Financial would want to look for Colorado companies with high in-state sales volumes and narrow profit margins (for example, grocery stores and gas stations), since purchasing this type of entity would likely be the most cost-effective way of acquiring favorable tax attributes. By bringing these Colorado companies into Principal's common control group, Principal would reduce the percentage of its income that would be apportioned to Iowa (thus significantly reducing its Iowa tax liability). Granted, Principal's Colorado tax liabilities would rise, but with Colorado being a low-tax state, the decrease in Iowa taxes would more than offset the increase in Colorado taxes.

The unitary business test makes these tax-motivated transactions more difficult: not only does Principal Financial have to acquire the grocery stores

176. See *supra* note 22 and accompanying text for a further discussion of this point.

177. Differences in apportionment factors render this analysis more complex, as there can thus be no single metric of a business's profitability. If, for instance, a company has high sales relative to payroll and property, the company will be considerably less "profitable" in the eyes of a state that apportions according to sales alone than in those of a state that apportions according to sales, payroll, and property. This will be a wrinkle in the calculus of firms, but it does not change the fact that apportionment-related tax incentives will exist for both acquisition and divestment.

178. See FED'N OF TAX ADM'RS, *supra* note 175; MD. BUS. TAX REFORM COMM'N, *supra* note 120. I am grateful to Daniel Hemel for the entirety of this example.

179. See FED'N OF TAX ADM'RS, *supra* note 175.

and gas stations, but it also has to integrate the grocery stores and gas stations into its businesses. By facilitating these tax-motivated transactions, the common control test might: (a) allow sophisticated entities to avoid state corporate taxes (thus narrowing certain states' tax bases), and (b) lead to deadweight loss from M&A activity that generates no economic value.¹⁸⁰ On the other hand, the unitary business test—precisely because it is more difficult to manipulate—may force some firms into making even greater investments in tax evasion.¹⁸¹ A higher bar may deter some, but it may also spur others to greater efforts. Those firms with the most to gain from being treated as unitary could be expected to sink greater investments into creating the indicia of unity in order to pass muster under the unitary business test (by, for instance, ensuring that there were common directors between the businesses at issue). These investments are deadweight losses. On balance, then, it is not clear whether the unitary business test or the common control test would create more inefficiency through tax-induced M&A activity.

Tax-induced *divestment* is an equally worrisome possibility. Suppose, for instance, that a Colorado subsidiary of Iowa-based Principal Financial Group were highly profitable and had low in-state sales (the opposite of the desirable acquisition target described above). If Principal divested itself of this subsidiary, the overall tax liability of Principal and the Colorado entity would be lower, as more profits would then be apportioned to low-tax Colorado and less to high-tax Iowa. In addition to this incentive to divest, there is also the worry that otherwise efficient M&A activity will be discouraged because companies at the margin will want to avoid the effects of combining and apportioning their income. (This would be the case, for instance, if Principal did not own, but wanted to acquire, the Colorado entity for strategic reasons.)

As was the case with tax-induced M&A activity, there is the danger here that: (a) sophisticated entities will avoid state corporate taxes through divestment, and (b) deadweight losses will result from inefficient divestment and from avoidance of efficient M&A activity. When it comes to tax-induced divestment, however, these criticisms apply equally to the status quo because states currently use a control standard that is arguably as easily evaded as the threshold of the common control test.¹⁸² The substantive analysis employed by

180. Note that the help of the federal government, which has been mentioned as an advantage of using the common control test, is of no use here. This is because the federal test polices only against tax avoidance by means of fragmentation, not aggregation. Unlike at the state level, there are no benefits to be gained at the federal level through aggregation and therefore no need to police against it.

181. See *supra* note 169 for a discussion of this effect.

182. See *supra* notes 169-171 and accompanying text.

the unitary business test is of no help here because the standard for aggregation is conjunctive: once a group of businesses falls below the control level it cannot be considered unitary no matter how integrated or centralized its operations. Thus, although tax-induced divestment and related problems may produce inefficiencies, this is not a reason to oppose adoption of the common control test per se.

C. Barriers to Implementation

So far, this Note has discussed the common control test as if the test would be adopted in all fifty states at once. There are, however, serious practical hurdles to adoption. Even if Congress has the power under the Commerce Clause to force all of the states to adopt the common control test,¹⁸³ this is unlikely to occur given Congress's long history of non-interference in state taxation.¹⁸⁴ It would be left to the states, then, to voluntarily adopt the test. Two considerations would be foremost in the minds of a state's legislators in considering adoption: (1) how adopting the common control test—a part of the *federal* income tax regime—might affect the state's sovereignty over levying its taxes, and (2) how the common control test would affect the state's tax revenues. This Section considers these two issues in turn and then analyzes what might transpire if only some states were to adopt the test.

If the states were to adopt the common control test, they would lose their ability to interpret and apply their own particular version of the unitary business test and would relinquish the delineation of the taxable entity to the federal government. This delineation is, however, precisely the kind of mechanical process that the states have shown themselves entirely willing to outsource to the federal government.¹⁸⁵ The vast majority of state corporate

183. If the Supreme Court had used only the dormant Commerce Clause as a basis for restricting state taxation, Congress would now undoubtedly have the power to regulate in this area under its Article I commerce power. But because the Court has also relied on the Due Process Clause, its rulings arguably cannot be changed by congressional enactment because Congress is bound, under the Fifth Amendment, to the strictures of due process. See *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 331 (1982) (O'Connor, J., dissenting) ("Far more dismaying, however, is that the Court's reliance on the Due Process Clause may deprive Congress of the authority necessary to rationalize the joint taxation of interstate commerce by the 50 States."); RONALD D. ROTUNDA & JOHN E. NOWAK, *TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE*, § 13.4(e)(i) (4th ed. 2007).

184. See ZIMMERMAN, *supra* note 15, at 153-73; Hellerstein, *supra* note 23, at 37.

185. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 7.02 ("Pressure from taxpayers for easing compliance and auditing burdens has been the prime force responsible for the very wide conformity of the state corporate income tax base to the federal corporate income tax base,

income tax provisions are adopted wholesale from federal legislation, and many states automatically track changes in relevant federal legislation.¹⁸⁶ In addition, most states follow federal regulations and rules, as well as federal court determinations of liability for individual taxpayers.¹⁸⁷ Some states even allow combined reporting wherever a group of entities files a consolidated federal return, which effectively gives businesses the option to delineate on the basis of a *federal*, ownership-based standard.¹⁸⁸ Such incorporation and piggybacking represent a far greater abdication of sovereignty over taxation than would the adoption of the common control test. Delineation is simply one of many steps involved in determining the taxable income of a business, and the states have already recognized, by their decision to piggyback on federal tax provisions,¹⁸⁹ that the bulk of this determination is best left to the federal government. The areas over which states are most anxious to retain control—tax rates and provisions that incentivize or discourage behavior—are not implicated by delineation.¹⁹⁰ The only genuine concern for states in adopting the common control test is its effect on tax revenue.¹⁹¹

As discussed above in Section I.A, the effect that aggregating the income of related entities has on a state's tax revenues depends on the relative

prior to allocation or apportionment of the base among the states in which the corporation is taxable.”). Although there is sometimes a worry that states will be “carried” in the wrong direction when they piggyback on the federal income tax, there is no danger of this here because the federal government can be expected to develop and apply the test in a way that is consistent with the interests of the states, as shown *supra* note 117 and accompanying text.

186. This automatic tracking is known as “dynamic incorporation.” See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 7.02; Dorf, *supra* note 45, at 108-10.

187. See HELLERSTEIN & HELLERSTEIN, *supra* note 45, ¶ 7.02[4].

188. See, e.g., FLA. STAT. ANN. § 220.131 (West 2005) (allowing for the filing of a combined state tax return in those cases where a federal consolidated return has been filed, provided the group is identical). For a discussion of the federal, ownership-based standard for filing a consolidated return, see *supra* Section III.C.

189. See *supra* notes 45-46.

190. The Connecticut Supreme Court, for example, in upholding the constitutionality of a state statute that incorporated the federal definition of gross income, noted that

[t]he state legislature and not the Congress has selected net earnings as the base for determining the amount of this tax and has fixed the rate to be paid on that tax base. As a matter of convenience to the taxpayer and economy to the state, the legislature has adopted some of the standards [including the definition of gross income] employed in the federal corporation net income tax law.

First Fed. Sav. & Loan Ass'n of New Haven v. Connelly, 115 A.2d 455, 460 (Conn. 1955).

191. Potential diminutions in tax revenue have been the largest motivator for states to “decouple” from federal tax legislation. See *supra* note 117.

profitability of the in-state and out-of-state entities (taking into account any discrepancies in apportionment factors between the states in question).¹⁹² Thus a state's revenue will increase if relatively unprofitable in-state entities are aggregated with relatively profitable out-of-state entities. If we assume that the common control test would aggregate entities more frequently than does the unitary business test (as seems likely), then states that have relatively less profitable businesses would gain from adopting the common control test and those with relatively more profitable businesses would lose. Although it is difficult to know which states will fall into which of these camps, one can make out a rough case for why high-tax states will likely be the losers. Capital moves to the state in which it can earn the highest net-of-tax return.¹⁹³ Where capital could earn a greater net-of-tax return in another state, it shifts to this state, and the process can theoretically be expected to continue until an equilibrium is reached. If this is correct, then projects in high-tax states will on average be more profitable (to compensate for the higher taxes) than those in low-tax states.¹⁹⁴ Combining this with the analysis above, states with high corporate tax rates would lose tax revenue if the common control test were adopted, while those with low corporate tax rates would gain revenue. The question is a complex one, however, and this conclusion is therefore tentative.

Whatever loss of tax revenue might result from more frequent aggregation must, of course, be weighed not only against the administrative costs saved in moving to the common control test (from outsourcing, simplicity, use of federal enforcement, etc.), but also against the business that a state might attract by virtue of having a simpler tax system.

Finally, what would happen if only some states were to adopt the common control test? At first blush, such inconsistency would seem to make the landscape of state corporate tax yet more burdensome. The effect is more nuanced than that, however, and cuts both ways. Because the common control group must be determined for federal tax purposes, there is no additional cost to using the test at the state level. All of the work is already done in filing the

^{192.} See *supra* note 22 and accompanying text.

^{193.} See Lucas Bretschger & Frank Hettich, *Globalisation, Capital Mobility and Tax Competition: Theory and Evidence for OECD Countries*, 18 EUR. J. POL. ECON. 695, 698 (2002) ("Assuming rational behaviour, capital moves across borders to seek the highest net-of-tax return.").

^{194.} Although this seems likely, it is not necessarily true. If operations in low-tax states were extremely profitable *only in those states* and if operations in high-tax states were less profitable and would be even less profitable if moved to low-tax states (by enough of a margin such that they would not migrate to low-tax states by reason of the difference in tax rates), then we might expect operations in low-tax states to be relatively more, not less, profitable.

federal Form 1120. The application of the unitary business test, on the other hand, is inconsistent as between states,¹⁹⁵ and, therefore, alleviating the burden of even one unitary business determination is a saved cost. (There are thus no network effects that would make initial, unilateral adoption of the new approach unlikely.)¹⁹⁶ However, insofar as the common control test differs more from the unitary business test than do the states' applications of the unitary business test one from another (and this seems likely), there might be an incrementally greater degree of inconsistency among the states' delineations of the taxable entity if only some states adopted the unitary business test.

CONCLUSION

Delineating the scope of the entity that an individual state is entitled to tax is a problem that has been around as long as the states have sought to apportion the income of businesses. The heart of this Note has been the observation of a parallel between federal and state taxation and of the opportunities that this parallel affords to solve the delineation problem. This Note's proposal draws upon what is acknowledged to be the greatest tax-related advantage that American states have over groups of jurisdictions without a central power, like the European Union: the ability to piggyback on the administration of a central income tax.¹⁹⁷

The common control test would be trivially easy for states to implement and would be a significant improvement on the status quo and on all other formal tests to have been previously put forward. Both the benefits of piggybacking and the need for a more objective test of unity have been well recognized; the common control test is a way to offer us both.

195. See *supra* Section II.C.

196. Network effects and resulting path dependency can sometimes prevent the adoption of superior systems. See Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332 (1985) (discussing the path dependency and network effects that led to the adoption and persistence of the QWERTY keyboard configuration).

197. See Hellerstein & McLure, *supra* note 4, at 217 (noting that the one thing American states do well is something that cannot be imitated by the European Union: conformity to a federal tax base).

