No. __-___

IN THE

Supreme Court of the United States

TESORO CORPORATION AND SUBSIDIARIES,
Petitioners,

v.

STATE OF ALASKA, DEPARTMENT OF REVENUE,
Respondent.

On Petition For Writ Of Certiorari To The Supreme Court of Alaska

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Petitioner Tesoro Corporation owned two disparate groups of subsidiaries—one called "E&P" that explored for and produced natural gas in Texas and Bolivia, and one called "R&M" that refined and marketed crude oil in Alaska. All, including the Alaska Supreme Court, agreed that E&P and R&M were neither vertically nor horizontally integrated. Yet the Alaska Supreme Court held that E&P and R&M were "functionally integrated" and thus part of a "unitary business" under this Court's precedents, thereby allowing Alaska to tax $75 million in income from E&P's out-of-state natural gas enterprise.

The Alaska Supreme Court also concluded that the Department of Revenue's hybrid approach for apportioning Tesoro's income—under which it counted "extraction" revenues only in states where Tesoro had extraction activities—violated the Commerce Clause's internal-consistency requirement and actually exposed Tesoro to the risk of double taxation. Yet it refused to redress the constitutional violation on the view that Tesoro did not face the "actual injury" of an increased Alaska tax burden.

The questions presented are:

(1) Does the Due Process Clause permit a finding that an in-state taxpayer and an out-of-state business under common ownership are unitary when the two are neither vertically nor horizontally integrated?

(2) Even if businesses could be unitary in the absence of vertical or horizontal integration, is exposure to the risk of double taxation a sufficient injury to trigger relief for a violation of the Commerce Clause's internal-consistency requirement?

PARTIES TO THE PROCEEDING

Petitioners are Tesoro Corporation, a publicly traded company headquartered in San Antonio, Texas, and its wholly owned subsidiaries. There is no parent company or publicly held company owning 10% or more of any Petitioner's stock.

Respondent is the State of Alaska, Department of Revenue.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners Tesoro Corporation and Subsidiaries respectfully petition for a writ of certiorari to review the judgment of the Supreme Court of Alaska.

OPINIONS BELOW

The Alaska Supreme Court's opinion (Pet. App. 1a) is reported at 312 P.3d 830. The Alaska Superior Court's decision, *see id.* at 48a, and the decisions of the administrative law judge, *see id.* at 81a, 155a, are unreported.

JURISDICTION

The Alaska Supreme Court issued its opinion on October 25, 2013. Pet. App. 1a. On January 9, 2014, Justice Kennedy granted a thirty-day extension, up to and including February 24, 2014, to file this petition. This Court has jurisdiction under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Due Process Clause of the Fourteenth Amendment to the United States Constitution provides: "nor shall any State deprive any person of life, liberty, or property, without due process of law." U.S. CONST. amend. XIV.

The Commerce Clause of the United States Constitution provides in relevant part: "The Congress shall have power . . . [t]o regulate commerce . . . among the several states." U.S. CONST. art. I, § 8, cl. 2.

Alaska Statutes section 43.20.144, previously codified as Alaska Statutes section 43.20.072, is involved in this case and is set out in full in the Appendix to

this Petition. *See* Pet. App. 174a-179a; *see also id.* at 6a n.10 (noting 2012 renumbering).[1]

Alaska Statutes section 43.19.010, article IV, section 18, provides:

> If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) separate accounting;
>
> (b) the exclusion of any one or more of the factors;
>
> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

STATEMENT

"As a general principle, a State may not tax value earned outside its borders." *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). Thus,

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[1] The statute was codified as section 43.20.072 for most of the course of this case. Petitioners follow the convention of the Alaska Supreme Court and refer to the statute as section 43.20.144 ("§ .144") in accordance with the 2012 renumbering.

the Fourteenth Amendment's Due Process Clause allows a state to base its income taxes upon the entire apportioned income of a multistate business only if the business is "unitary." *Mobil Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425, 438 (1980). "Unitary" means that the business's "intrastate and extrastate activities" experience "contributions to income resulting from functional integration, centralization of management, and economies of scale." *Id.*

An unbroken line of authority from this Court establishes that vertical or horizontal *integration* of in-state and out-of-state businesses is a necessary condition, but not always a sufficient condition, for establishing the "functional *integration*" required before businesses may be deemed unitary. *Id.* (emphasis added). The Alaska Supreme Court departed from this authority and created a split among state courts of last resort when it held that Tesoro's group of Texas and Bolivia natural gas subsidiaries ("E&P") and its group of Alaska crude oil subsidiaries ("R&M") were "functionally integrated" (and thus unitary) even though they were admittedly neither vertically nor horizontally integrated. Pet. App. 16a–20a. This departure from the Court's precedents turned the crucial constitutional limitation embodied in the unitary-business principle into no limit at all. The Alaska Supreme Court's decision instead constitutes a sweeping license for states to treat all commonly owned groups of companies as "unitary" based on nothing more than the ordinary incidents of common corporate ownership.

A holding from this Court that functional integration requires vertical or horizontal integration, and thus that Alaska's apportionment method cannot stand, would resolve the case under Question 1 of this petition, and should obviate the need to address the internal-consistency problem with that apportionment method that is presented by Question 2. *See supra* at i. If, however, Tesoro's businesses could somehow be found to be "functionally integrated" and subjected to formula apportionment even in the absence of vertical or horizontal integration, then the hybrid formula-apportionment scheme that Alaska applied to Tesoro violated the Commerce Clause's internal-consistency requirement. That limitation is another bulwark against overexuberant state taxation of multistate enterprises. It obliges a state to structure its tax "so that if every State were to impose an identical tax, no multiple taxation would result." *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989). The Alaska Supreme Court explicitly recognized that the Department of Revenue's hybrid approach to apportioning Tesoro's income to the states where its subsidiaries conducted business violated this requirement. Pet. App. 28a. Yet it held that Tesoro could not seek redress for this violation because it did not claim "actual injury" in the form of a higher Alaska tax burden. *Id.* at 34a. This holding departed from this Court's binding precedents on internal consistency and eroded this vital constitutional limitation on state taxing authority.

A. Alaska's Unconstitutional Petroleum Business Income Tax

Because a state may not tax value earned outside its borders, taxing authorities have developed two principal methods to determine a state's taxable portion of a multistate business's income: separate accounting and formula apportionment. Separate accounting seeks to carve out of the taxpayer's overall business the income derived from sources within a single state, and to determine the profits attributable to that portion of the business. *See Mobil Oil*, 445 U.S. at 438. Formula apportionment applies a formula—traditionally incorporating the ratios of the business's in-state and total property, sales, and payroll—to determine the state's taxable "share" of the business's total income. *Id.* at 438–39. The necessary constitutional precondition for formula apportionment—in the words of this Court, "the linchpin of apportionability"—is that the multistate business be a "unitary business." *Id.* at 439.

From 1978 to 1981, Alaska utilized a form of separate accounting for petroleum businesses. *See* Alaska Stat. § 43.21 (repealed 1982). In 1982, the Alaska Legislature replaced that scheme with a form of formula apportionment now codified in Alaska Statutes section 43.20.144 ("§ .144"). *See id.* § 43.20.144. Section .144 purports to set out the tax scheme for "a taxpayer engaged in the production of oil or gas" or "the transportation of oil or gas by pipeline" in Alaska. *Id.* § 43.20.144(a). But § .144 applies different apportionment factors depending on which of those activities the business conducts in Alaska. In particular, § .144 prescribes (1) a two-factor property and extraction formula for a business

conducting oil or gas production activities in Alaska; (2) a two-factor property and sales formula to a business conducting pipeline activities in Alaska; and (3) a three-factor property, sales, and extraction formula for a business conducting both activities in Alaska. *See id.* § 43.20.144(c). A business conducting neither production nor pipeline activities in Alaska is subject to the traditional property, sales, and payroll formula under the Uniform Division of Income for Tax Purposes Act (UDIPTA), even if it conducts either or both activities in another state. *See id.* § 43.19.010, art. IV, §§ 9–17.

Alaska also has enacted § 18 of the UDIPTA ("§ 18"). *See id.* § 43.19.010, art. IV, § 18. Section 18 permits deviations from statutory formula apportionment where that approach "do[es] not fairly represent the extent of the taxpayer's business activity in this state." *Id.* In such cases, § 18 authorizes the use of "separate accounting" or "the inclusion of one or more additional factors" in the apportionment formula. *Id.* § 18(a), (c).

In an October 1999 opinion, the Alaska Attorney General acknowledged that § .144 violates the constitutional requirement of internal consistency, and advised the Legislature to review § .144 "in its entirety and determine whether legislation should be proposed to cure constitutional deficiencies." Office of the Attorney General, State of Alaska, File No. 223-99-0227, 1999 WL 1337804, at *6 (Alaska Att'y Gen. Oct. 20, 1999). The Attorney General recommended that, in the interim, § 18 be used as "a constitutional circuit breaker" in cases where § .144 "result[s] in the unconstitutional taxation of a unitary business." *Id.* In acknowledgement of the Attorney General's

opinion, Respondent issued an advisory letter stating that it would use § 18 to adjust the apportionment formula applicable to petroleum businesses under § .144. Pet. App. 8a–9a. To date, the Alaska Legislature has failed to cure the statute's constitutional infirmity.

B. Tesoro's Nonunitary Business During The Audit Period

During the 1994 to 1998 audit period at issue in this case, Tesoro, the parent company, conducted no business operations at all. Pet. App. 3a–4a. Instead, it was a holding company of two main subsidiary business units: E&P, a Texas and Bolivia natural gas exploration and production segment, and R&M, an Alaska crude oil refining and marketing operation. *Id.*[2]

The findings of the Administrative Law Judge ("ALJ") demonstrate that these two business units had little in common with one another. It is undisputed, as the ALJ found, that E&P and R&M "lack[ed] vertical or horizontal integration" and had no direct connection to each other. *Id.* at 113a; *see also id.* at 62a. "E&P was a gas business, while R&M was an oil business, and the two segments were in many ways dissimilar." *Id.* at 114a. Thus, "there was little or no flow of products or operational expertise between" them, and there were few, if any, "opportunities for operational synergies." *Id.* at 61a–62a.

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[2] Tesoro also owned a small number of Marine services operations in Texas and Louisiana, but those operations are not at issue in this case. *See* Pet. App. 3a n.3.

E&P and R&M were also centered in "different geographical locations," thousands of miles away from one another. *Id.* at 86a. E&P had no companies in common with R&M. *See id.* In fact, E&P had no employees, property, or activity in Alaska during the audit period. *See id.*

As would be expected from a parent holding company, Tesoro's executive management was "principally trained in finance" and "lacked the operational expertise or experience to run the operating segments." *Id.* at 100a. E&P and R&M therefore had strong, autonomous local management that ran each segment's "day-to-day operations independently" and made long-term decisions without involvement from the parent company (Tesoro). *Id.* at 62a. The companies comprising E&P and R&M had their own separate boards of directors regularly compromised of Tesoro's top three executive officers. *Id.* at 97a.

Tesoro performed limited basic functions and oversight for E&P and R&M, as one would expect from a parent holding company. Tesoro was involved in financial matters affecting its return on investment, including negotiating and guaranteeing major loans and credit facilities to secure favorable interest rates, and overseeing each subsidiary's capital investments. *Id.* at 92a, 110a. Tesoro's board approved annual budgets, major expenses, and significant projects. *Id.* at 19a. Tesoro also provided guidance on personnel matters such as employee salaries and benefits. *Id.* And, like most parent holding companies, Tesoro performed some consolidated services on behalf of its subsidiaries, including information technology services, internal

auditing and accounting, insurance and risk management, and legal affairs. *Id.* at 105a. State and federal law compelled Tesoro to perform several of these functions on a consolidated basis, such as EEOC and Veterans Employment report filings; SEC filings; federal income tax filings; and environmental compliance oversight. *Id.* at 112a; *see also, e.g.*, 26 U.S.C. § 1501.

C. The Subsidiaries' Operations And Income During The Audit Period

E&P (Texas and Bolivia). E&P was a group of corporations and partnerships that explored for, produced, and marketed natural gas primarily in Texas and Bolivia. Pet. App. 3a. E&P was enormously profitable during the audit period, due largely to two events. *Id.* at 4a. First, in 1995, E&P sold a portion of the Bob West natural gas field in Texas for $68 million. *Id.* at 52a. Second, in 1996, after prevailing on a very important appeal in the Texas Supreme Court, *see Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565 (Tex. 1996), E&P received a back payment of $67.7 million for certain contract rights related to the Bob West field. Shortly thereafter, E&P sold the remainder of those contract rights for $60 million. Pet. App. 52a. Tesoro used this approximately $127 million from E&P's operations in Texas to finance E&P's capital expenditure program and to fully redeem Tesoro's public debt issuances. None of the proceeds went to R&M. Tesoro sold E&P's domestic and Bolivia operations as going concerns, each to a separate buyer, in 1999, after the end of the audit period. *Id.* at 84a.

R&M (Alaska). R&M is a distinct group of corporations and partnerships that refined crude oil purchased from third parties into a slate of products and marketed those products to customers. *Id.* at 3a. At the start of the audit period, R&M's only refinery was in Kenai, Alaska, and its retail operations were solely in Alaska. *Id.* at 85a. During 1998, R&M's operations expanded to include refineries in Washington and Hawaii and retail operations along the West Coast. *Id.* R&M realized very low profit margins during the majority of the audit period, and, when calculated according to the separate accounting method, its profits attributable to Alaska during the audit period were less than $14 million. *Id.* at 43a.

D. The Department's Assessments And The Decisions Below

R&M became a "petroleum business" subject to § .144 for the first time in 1995, when it purchased a short pipeline that it had previously leased connecting its Kenai refinery to nearby dock facilities. *Id.* at 51a. Tesoro treated E&P and R&M as non-unitary on its operative Alaska tax returns during the audit period, and applied separate accounting to compute its Alaska tax burden for R&M's in-state income. *Id.* at 6a–7a.

The Department "rejected Tesoro's position" that E&P and R&M were not unitary and Tesoro's request for separate accounting. *Id.* at 7a. Instead, the Department determined that E&P and R&M were unitary and subjected Tesoro "to modified apportionment" under § .144. *Id.* at 8a. Thus, for the 1995 tax year, the Department "apportioned all of Tesoro's business income under the two-factor property and sales formula . . . for nine months of

1995 to account for [the] March 1995 purchase" of the Kenai pipeline. *Id.*

For the 1996, 1997, and 1998 tax years, the Department "applied a three-factor" property, sales, and extraction formula to Tesoro company-wide because R&M conducted pipeline activities in the state. *Id.* at 9a. At the same time, Alaska statutes and the Department's approach called for application of the UDIPTA's three-factor property, sales, and payroll formula in any state, such as California or Texas, where Tesoro's subsidiaries conducted business but did not have production or pipeline activities. *Id.* at 5a, 30a–31a. As a result, the hybrid tax scheme implemented by Alaska and the Department exposed Tesoro to the risk of taxation of approximately 106.7% of its income. *Id.* at 31a.

Wielding its "modified apportionment" formulas, the Department captured for taxation approximately $89 million in income generated by Tesoro's subsidiaries. *Id.* at 48a. That figure represented $75 million and *six times* more income than the $14 million R&M generated in Alaska during the audit period. *Id.* at 49a. The Department also imposed 30% penalties—for a total amount of $1,757,144—on Tesoro in part for taking the position that E&P and R&M were not unitary. *Id.* at 78a. The total assessment of taxes, interest, and penalties was $10,789,138, more than 75% of R&M's Alaska earnings as calculated under a separate accounting method. *See id.*

Tesoro appealed the Department's assessments to the ALJ. *Id.* at 81a. The ALJ found that E&P and R&M were not horizontally or vertically integrated, that they autonomously operated "dissimilar"

businesses in different locations, and that "there were not significant flows of product or personnel directly between them." *Id.* at 114a. The ALJ nonetheless concluded that E&P and R&M were "unitary" based on their common ownership by Tesoro, their receipt of certain administrative services from Tesoro, the overlapping membership of their boards, and Tesoro's centralization of certain, albeit limited, services. *Id.* at 88a–91a. The ALJ thus upheld the Department's imposition of penalties on Tesoro and its application of formula apportionment to Tesoro. *Id.* at 153a.

The ALJ also recognized that "[t]he problem with having a tax that would use a different number of apportionment factors in different states is that if this Alaska tax were used by other states, the result could be that more than 100% of the taxpayer's income could be apportioned between the states it does business in." *Id.* at 161a. It nonetheless upheld the Department's hybrid tax scheme against Tesoro's internal-consistency challenge. *Id.* at 161a–163a.

The Alaska Superior Court, sitting as an appellate court, affirmed. *Id.* at 80a. The Superior Court noted that E&P and R&M "were not integrated either horizontally or vertically," "ran day-to-day operations independently," operated in "two quite different parts of the petroleum industry," and had few, if any, "opportunities for operational synergies." *Id.* at 62a. Yet like the ALJ, the Superior Court concluded that E&P and R&M were unitary based on the routine incidents of the parent-subsidiary relationship such as "overlap[ping]" boards, consolidated human resources and administrative services, and "[c]ollective financing." *Id.* at 61a. The Superior

Court upheld the imposition of penalties and the use of formula apportionment. *Id.* at 66a–67a, 77a–80a.

The Superior Court devoted a single paragraph of its 29-page decision to the internal-consistency inquiry, and did not examine whether the Department's hybrid tax scheme created a risk that Tesoro would be subject to taxation on more than 100% of its income. *Id.* at 76a. The Superior Court nonetheless "agreed" with the ALJ that, as "applied to this taxpayer," the Department's tax scheme was constitutional, and thus did not grant any relief. *Id.*

Tesoro then appealed to the Alaska Supreme Court, which affirmed. *Id.* at 2a–3a. Invoking its prior precedent—including its dubious holding in *Earth Resources Co. of Alaska v. State, Department of Revenue*, 665 P.2d 960, 968 (Alaska 1983), that two disparate businesses constituted a unitary enterprise[3]—the Alaska Supreme Court held that E&P and R&M were functionally integrated and therefore unitary even though they were undisputedly not "vertical[ly] or horizontal[ly]" integrated. *Id.* at 25a. The Alaska Supreme Court further held that the Department's penalties were "permissible" because Tesoro had taken the

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[3] As the Alaska Supreme Court recognized, a "respected treatise" has criticized that court's *Earth Resources* holding. *See* Pet. App. 25a (citing 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶ 8.10[2][a][ii], at 8-159 to 8-162 (3d ed. 2012), which noted: "If other courts were to follow the narrow definition of separate businesses adopted by the Alaska court in *Earth Resources*, it would weaken the separate business rule, at least as that rule has traditionally been understood.")).

"obvious[ly] invalid[]" position that E&P and R&M were not unitary. *Id.* at 45a. It also held that the Department's use of formula apportionment rather than separate accounting was permissible. *Id.* at 36a–37a.

The Alaska Supreme Court recognized, however, that the Department's hybrid formula-apportionment scheme violates the constitutional internal-consistency requirement because, if applied by every state in which Tesoro does business, it would "result in more than 100% of a taxpayer's income being taxed." *Id.* at 28a. This result follows, as the Alaska Supreme Court acknowledged, because the Department's scheme "applies . . . two different apportionment formulas" with different factors "depending on a taxpayer's in-state business activity." *Id.*

The Alaska Supreme Court nonetheless upheld the Department's hybrid scheme as applied to Tesoro. *Id.* at 33a–34a. According to the Alaska Supreme Court, Tesoro had not suffered any "actual injury" or been "adversely affected" by the Department's scheme because the demonstrated internal inconsistency had not "increased its tax burden in Alaska." *Id.* The Alaska Supreme Court thus held that there had been no showing that "*this* state, Alaska, has treated [Tesoro] unfairly." *Id.* at 35a (emphasis in original).

The Alaska Supreme Court did not explain why the risk of double taxation that Tesoro faced from the Department's hybrid scheme was not an "actual injury" or "adverse[] [e]ffect" sufficient to confer standing. *Id.* at 33a–34a. Instead, it rested on the reasoning that the "6.7% of double taxation" Tesoro would have faced if the Department's scheme had

been adopted in all 50 states "is the amount by which California's hypothetical property, sales, and payroll apportionment would exceed California's hypothetical property, sales, and extraction apportionment." *Id.* Yet the Alaska Supreme Court did not mention, much less square its holding with, the fact that "*this* state, Alaska" had actually imposed the tax scheme that dictated California's "hypothetical" choice between two apportionment formulas. *Id.* at 35a (emphasis in original). It therefore did not explain how Tesoro's "actual injury"—the risk of double taxation and an increased tax burden in other states where it does business—was not caused by Alaska's internally inconsistent tax scheme or redressable by the Alaska Supreme Court. *Id.* at 33a–35a.

REASONS FOR GRANTING THE PETITION

The Alaska Supreme Court's decision represents a substantial departure from this Court's unitary-business and internal-consistency decisions and creates a split of authority among state courts of last resort. If left standing, the Alaska Supreme Court's decision would open the door for all states to ignore two of the principal bulwarks against overreaching state taxation.

First, the Alaska Supreme Court contravened this Court's precedents and the decisions of at least three other state courts of last resort when it held that two companies owned by a common parent can be functionally integrated and thus unitary even when they are not vertically or horizontally integrated. The Alaska Supreme Court thus transformed the unitary-business principle from a critical limitation on state taxing authority into an unbounded license to treat all commonly held groups of companies as

unitary. Because the unitary-business principle is "the linchpin of apportionability," *Mobil Oil*, 445 U.S. at 439, the Alaska Supreme Court's decision will serve as a roadmap for other states' taxing authorities to tax value earned outside their borders and lacking any meaningful connection to the taxing state. This important, recurring issue is squarely presented in this case. In fact, the Court's clarification that functional integration requires actual integration, either vertical or horizontal, would require use of a different, constitutionally permissible allocation method, such as separate accounting, with respect to Tesoro and resolve this case in its entirety.

Second, the Alaska Supreme Court again departed from this Court's precedents when it conditioned relief for an internally inconsistent tax scheme on the additional showing of the "actual injury" of an increased Alaska tax burden. Pet. App. 33a–34a. The Alaska Supreme Court thus narrowed this second constitutional limitation to its vanishing point, and left standing a tax that is an impermissible—and indisputable—burden on interstate commerce. The Court should grant certiorari.

I. THE ALASKA SUPREME COURT'S DRAMATIC EROSION OF THE UNITARY-BUSINESS REQUIREMENT WARRANTS THIS COURT'S REVIEW

A. The Alaska Supreme Court's Decision Conflicts With This Court's Precedents Establishing Functional Integration As A Necessary Prerequisite To A Unitary-Business Finding

In its five cases developing the modern unitary-business test, this Court has *never* found functional integration where, as here, the companies' operations are neither vertically nor horizontally integrated. In fact, this Court has made clear that, while *necessary*, even the presence of vertical or horizontal integration may not be *sufficient* to establish the existence of a unitary business.

This Court first articulated the modern unitary-business test in its 1980 *Mobil Oil* decision, where it identified the three "factors of profitability," including functional integration. *See* 445 U.S. at 438. The Court emphasized that two business segments are not unitary if the income of one in one state is "earned in the course of activities unrelated" to activities of the other in another state. *Id.* at 439. The Court held that Mobil's vertically integrated business enterprise materially benefited from the three factors of profitability and, thus, that Vermont could tax a portion of income generated by Mobil's unitary foreign subsidiaries even though those subsidiaries did not conduct any business in the state. *See id.* at 441–42.

Three months later, this Court applied the same rationale in *Exxon Corp. v. Wisconsin Department of*

Revenue and determined that the vertical (and horizontal) integration of Exxon's business allowed Wisconsin to tax an apportioned amount of income received from Exxon's out-of-state operating divisions that had no independent connection with the state. 447 U.S. 207, 224 (1980).

Two years later, the Court made clear in a pair of decisions that even the presence of vertical or horizontal integration may not be sufficient to establish the presence of a unitary business. In *ASARCO*, the Court held that a vertically integrated parent and subsidiary were not unitary because the parent did not exercise actual control over the subsidiary's operations. 458 U.S. at 322–23.

F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico involved a horizontally integrated enterprise that this Court held was not unitary. 458 U.S. 354, 362, 364 n.11, 371 (1982). The Court emphasized that the taxpayer and the out-of-state business were not unitary even though the parent intermingled and used its subsidiaries' funds for general corporate purposes and provided centralized administrative services. *See id.* at 365–66. The Court crucially recognized that the subsidiaries were not unitary where the parent wielded only potential, and not actual, control over them. *See id.* at 369–70. The Court thus made clear that local operational autonomy coupled with oversight by a common parent's executive management and the parent's provision of administrative services does not turn subsidiaries into a unitary business. *See id.* at 354, 369–70.

Finally, in 1983, the Court emphasized in *Container Corp. v. Tax Franchise Board* that the

unitary-business principle "could apply . . . to vertically integrated enterprises" and "to a series of similar enterprises operating separately in various jurisdictions but linked by common managerial or operational resources"—*i.e.*, horizontally integrated enterprises. 463 U.S. 159, 166 (1983). The Court held that the horizontally integrated enterprise in that case was unitary, in large part because the parent shared manufacturing and managerial expertise (including manufacturing techniques, engineering, design, and architecture) with its affiliates, all of which were engaged in the exact same business—the manufacture of custom-ordered paperboard packaging. *Id.* at 173.

This Court's precedents therefore establish that "[i]t cannot be enough" for functional integration that each of the businesses under common ownership "depends on and contributes to its parent." *In re Envirodyne Indus., Inc.*, 354 F.3d 646, 649 (7th Cir. 2004) (Posner, J.). "The concept of the unitary business group, to be a constitutional basis for taxing income earned out of state, must identify a genuine multistate enterprise—an enterprise that generates income which can't confidently be ascribed to a particular state in which the enterprise operates." *Id.* "If a holding company owns two unrelated companies that operate in two different states, the state in which one of them operates cannot tax the income of the other just because the two are affiliates and each is under the control of their common parent." *Id.*

The Alaska Supreme Court departed from this Court's precedents when it held that the disparate E&P and R&M businesses were nonetheless

functionally integrated and unitary even though they were neither vertically nor horizontally integrated. Pet. App. 25a. The Alaska Supreme Court's decision thus conflicts with this Court's authority and turns the crucial constitutional limiting principle embodied in the unitary-business test on its head. *See infra* Part I.C.

B. The Alaska Supreme Court's Decision Creates A Split Of Authority With At Least Three Other State Courts Of Last Resort

At least three other state courts of last resort have concluded that this Court's unitary-business cases require vertical or horizontal integration as a necessary—although not always sufficient—condition to a unitary-business holding. The Missouri Supreme Court thus declined to find unity where "there was no functional integration, *either vertical or horizontal*, between [the taxpayer] and any of the subsidiaries in question." *James v. Int'l Tel. & Tel. Corp.*, 654 S.W.2d 865, 869 (Mo. 1983) (citing *Woolworth*, 458 U.S. at 362 and *Mobil Oil*, 445 U.S. at 439, 442) (emphasis added).

The Minnesota Supreme Court likewise has recognized that "[a] unitary business may be *either vertically or horizontally* structured," although "something more" beyond vertical or horizontal integration "is needed" to prove unity. *Comm'r of Rev. v. Assoc. Dry Goods, Inc.*, 347 N.W.2d 36, 39 (Minn. 1984) (emphasis added).

And, the Ohio Supreme Court, in looking to this Court's decisions for guidance in applying Ohio's version of § 18, noted that unitary businesses "are characterized as being *either vertically or horizontally integrated* with horizontally integrated

businesses . . . being more difficult to characterize as unitary." *R.H. Macy & Co. v. Lindley*, 495 N.E.2d 948, 950 (Ohio 1986) (emphasis added).

The uniformity of these state-court decisions remained undisturbed for approximately 27 years until this case. The Alaska Supreme Court did not cite any of these cases or, in fact, any case from any other state for its novel holding that "functional integration" can exist *without* vertical or horizontal integration. *See* Pet. App. 25a. Instead, the only authority the Alaska Supreme Court invoked was its own prior decision that did not even address the question and has been criticized by a "respected treatise." *See id.* (citing *Earth Resources*, 665 P.2d at 969 and 1 Hellerstein, State Taxation ¶ 8.10[2][a][ii], at 8-159 to 8-162). Indeed, that "respected treatise" presciently warned that the *Earth Resources* approach, if applied by other courts, would "weaken the separate business rule" and "lead to bizarre results" and "serious risks of unfair apportionment," 1 Hellerstein, State Taxation ¶ 8.10[2][a][ii], at 8-159 to 8-162, just as it has done here. The Alaska Supreme Court thus created a 1-3 split in state courts of last resort on the question whether *functional* integration requires *actual* integration, in the form of either vertical or horizontal integration.

C. The Alaska Supreme Court's Rule Transforms A Crucial Constitutional Limitation Into No Limit At All

This Court devised the unitary-business test and the functional-integration requirement as a crucial "due process limitation" on states' "taxation powers," *Woolworth*, 458 U.S. at 363, and the constitutional "linchpin of apportionability," *Mobil Oil*, 445 U.S. at

439. These requirements therefore ensure that states do not overreach and attempt to capture for taxation "value earned outside [their] borders." *ASARCO*, 458 U.S. at 315.

This Court has made clear that the three prerequisites for a unitary business—"functional integration, centralization of management, *and* economies of scale," *Mobil Oil*, 445 U.S. at 438 (emphasis added)—are conjunctive, not disjunctive, requirements. Similarly, this Court's decisions establish the principle that the first of these three requirements—"functional integration"—requires at least one of the two varieties of corporate integration (vertical or horizontal) recognized by basic principles of business management. There is no kind of "functional integration" that is neither vertical nor horizontal, and this Court's decisions bear out that truism.

The requirement of vertical or horizontal integration to prove the presence of functional integration also makes perfect sense. Absent vertical or horizontal integration, no substantial value can be transferred between business segments. Vertical integration allows a taxpayer to coordinate a "series of transactions" among affiliates, *Mobil Oil*, 445 U.S. at 438–39; *Exxon*, 447 U.S. at 226, while horizontal integration may facilitate the sharing of operational functions, *see Container Corp.*, 463 U.S. at 166. But without either form of integration, an out-of-state business necessarily generates no "value" within the state's borders that the state "may" tax. *ASARCO*, 458 U.S. at 315. Thus, the requirement of vertical or horizontal integration is an irreducible constitutional

minimum for confining states' exercise of their "taxation powers." *Woolworth*, 458 U.S. at 363.

The rule applied by the Alaska Supreme Court "would destroy" this vital constitutional limitation on state taxing authority by turning it into "no limitation at all." *ASARCO*, 458 U.S. at 326. Instead, the Alaska Supreme Court's decision sanctions an unbounded license to tax value earned outside a state's borders merely because *every* corporate parent inherently provides the sort of financial and administrative support to its subsidiaries that Tesoro provided to its segments. As this Court has made clear, these ordinary incidents of common corporate ownership do not demonstrate a unitary business. *See supra* Part I.A. Yet the Alaska Supreme Court's holding would make every commonly owned group of companies unitary, and thereby render meaningless the Constitution's protections against extraterritorial taxation.

The mischief of the Alaska Supreme Court's rule is apparent on the face of its opinion. By eliminating actual integration in the form of vertical or horizontal integration as a requirement of unity, the State's "proof" of "functional integration" was limited to incidents of common parental ownership and evidence duplicative of the other two requirements of the unitary-business test. Pet. App. 16a–26a; *see also id.* at 94a–122a. Despite the total absence of evidence showing that Tesoro's Texas and Bolivia E&P business created any taxable value within Alaska, the State was able to prove to the Alaska courts' satisfaction that the two businesses were part of one combined group for taxing purposes because of these incidents. The Alaska Supreme Court also

upheld the Department's imposition of nearly $1.8 million in penalties on Tesoro for taking the position that E&P and R&M were not unitary. *Id.* at 44a–45a. Only the Alaska Supreme Court's evisceration of the unitary-business principle allowed this anomalous result to occur.

D. This Case Provides An Ideal Vehicle To Address This Important And Recurring Issue

"Functional integration" is in the front line of every battle over whether a unitary business exists. It serves a vital limiting function to restrain state taxing authority—and, thus, to facilitate the interstate and international commerce vital to the nation's economic prosperity. The explosive growth of the global economy in recent decades only underscores the need for a uniform nationwide construction of the unitary-business test in order to unburden interstate and international commerce from competing state tax regimes.

The Alaska Supreme Court's decision, however, destroys the uniformity established by this Court's unitary-business cases and acknowledged by other state courts of last resort. In so doing, the Alaska Supreme Court's decision turns the functional-integration limitation into no limit at all by sanctioning the treatment of all commonly held groups of companies as unitary. Left unreviewed, this case will provide the roadmap for state courts to follow the Alaska Supreme Court's lead, eviscerate the unitary-business limitation, and impermissibly capture out-of-state value in the in-state tax base.

This unbounded license to expand state income taxes beyond state borders would sweep far beyond

Alaska and the critical interstate petroleum industry. For example, according to a Westlaw search, this Court's decision in *Mobil Oil* has been cited in connection with the unitary business principle in no fewer than 182 reported state-court cases. That number, of course, does not include the numerous unreported cases, situations where taxpayers filed their tax returns as unitary businesses without protest, or cases where any issues related to a taxpayer's unitary status are resolved at the administrative level. Thus, if left unchecked, the Alaska Supreme Court's approach exposes interstate business to substantial potential tax liability across the country for value that may have been earned "outside [the taxing state's] borders." *ASARCO*, 458 U.S. at 315.

This case provides an ideal vehicle for the Court to prevent this untenable result and to reemphasize the fundamental contours of the functional-integration test. In the first place, it is undisputed that E&P and R&M were neither vertically nor horizontally integrated during the audit period, Pet App. 25a, so the Court's clarification that vertical or horizontal integration is required for businesses to be unitary would dispose of the entire case.

Moreover, the Alaska Supreme Court's misapplication of the functional-integration test placed substantial burdens on Tesoro and its subsidiaries. By holding that E&P and R&M were unitary despite the undisputed absence of vertical or horizontal integration, the Alaska Supreme Court allowed the Department to capture for taxation $75 million and *six times more* in income than the $14 million that R&M's Alaska activities generated. And

it upheld the imposition of nearly $1.8 million in penalties on Tesoro for taking what it termed the "obvious[ly] invalid[]" position that Tesoro and its subsidiaries were not unitary, in contravention of this Court's precedents and the decisions of other state courts of last resort that functional integration requires vertical or horizontal integration. *Id.* at 45a. The Court should grant certiorari and resolve this important, recurring question.

II. THE ALASKA SUPREME COURT'S SANCTIONING OF AN INTERNALLY INCONSISTENT TAX SCHEME WARRANTS THIS COURT'S REVIEW

A. The Alaska Supreme Court's Insistence On Actual Injury Above The Risk Of Double Taxation Conflicts With This Court's Precedents

Only if Tesoro's disparate and non-integrated E&P and R&M subsidiary groups are nonetheless held to be "unitary" does Question 2 of this petition, involving the Commerce Clause's internal-consistency requirement, arise. The Alaska Supreme Court's decision on this second issue is equally in conflict with this Court's precedents, most prominently *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984). The Court therefore should grant review as to both questions so that the constitutional injury suffered by Tesoro can be remedied even in the event that its non-integrated subsidiary groups were held to be unitary.

The internal-consistency requirement protects interstate commerce and obliges a state to structure its tax "so that if every State were to impose an identical tax, no multiple taxation would result."

Goldberg, 488 U.S. at 261; *see also Container Corp.*, 463 U.S. at 169. Because the injury inflicted by an internally inconsistent tax is the *risk* of multiple taxation, the internal-consistency inquiry has a "hypothe[tical]" cast to it: "[T]he internal consistency test focuses on the text of the challenged" tax scheme and "hypothesizes a situation where other States have" adopted an identical scheme. *Goldberg*, 488 U.S. at 261. "A failure of internal consistency establishes *as a matter of law* that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995) (emphasis added).

However, the fact that the internal-consistency test requires a court to "hypothesiz[e]" that every state has adopted the same tax scheme is not the same as saying that the injury inflicted by an internally inconsistent tax is itself "hypothetical." "This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate." *Id.*

This Court therefore has *never* required proof that the taxpayer challenging a scheme as internally inconsistent has suffered an "actual discriminatory impact" in the form of a higher tax burden. To the contrary, this Court in *Armco* rejected West Virginia's effort to "require Armco to prove actual

discriminatory impact on it by pointing to a State that imposes a manufacturing tax that results in a total burden higher than that imposed on Armco's competitors in West Virginia." 467 U.S. at 644. The Court emphatically rejected that argument: "This is not the test." *Id.*

In fact, as the Court noted, such harm or impact "would depend on the shifting complexities of the tax codes of 49 other States and . . . on the particular other States in which [the taxpayer] operated." *Id.* at 644–45. Thus, to establish an internal-consistency violation and attendant harm, the taxpayer need not demonstrate an increased in-state tax burden, but instead only that the tax scheme exposes it to the *risk* of "multiple taxation" if *all* 50 states adopted the scheme. *Goldberg*, 488 U.S. at 261. This of course flows from the proposition that the Commerce Clause "protects the interstate market, not particular interstate firms, from prohibitive or burdensome regulations." *Exxon Corp. v. Governor of Md.*, 437 U.S. 117, 127–28 (1978). Accordingly, it is the *risk* of such multiple taxation that burdens the free flow of commerce across state lines. *Armco*, 467 U.S. at 644.

There is no question here that the Department's hybrid approach to Tesoro's tax liability actually subjected Tesoro to this risk of multiple taxation—even the Alaska Supreme Court's opinion recognized as much when it noted that the Department's approach would subject more than 100% of Tesoro's income to taxation if it were implemented in every state. Pet. App. 28a. As this Court has explained, no more is required to prove an actionable internal-consistency violation. *See, e.g.*, *Armco*, 467 U.S. at 644–45. Yet the Alaska Supreme Court refused to

grant Tesoro relief from this constitutional violation because, in its view, Tesoro had not suffered "actual injury" in the form of a higher Alaska tax burden. Pet. App. 25a. The Alaska court's requirement of "actual injury" is indistinguishable from the West Virginia Supreme Court's effort to require "actual discriminatory impact," which this Court rejected in *Armco*. The Alaska Supreme Court's attempt to engraft this baseless requirement onto the internal-consistency test thus squarely and irreconcilably conflicts with this Court's controlling decisions.

B. The Alaska Supreme Court's Extraneous Injury Requirement Improperly Burdens Interstate Commerce

The Alaska Supreme Court's adoption of an additional requirement of in-state harm not only departs from this Court's authoritative construction of the internal-consistency test, but also imposes significant—and unconstitutional—burdens on interstate commerce. Indeed, the Alaska Supreme Court's decision sanctions the very outcome that the Commerce Clause and this Court's precedents squarely forbid because it *upheld* a tax scheme that indisputably exposes Tesoro to the actual injury and adverse effect of a risk of multiple taxation. *See, e.g.*, *Goldberg*, 488 U.S. at 261.

The Alaska Supreme Court offered no coherent, much less defensible, rationale for imposing this unconstitutional burden on interstate commerce. The Alaska Supreme Court reasoned that Tesoro did not suffer any cognizable harm in Alaska because the "6.7% of double taxation" it would have faced "is the amount by which California's hypothetical property, sales, and payroll apportionment would exceed

California's hypothetical property, sales, and extraction apportionment." Pet. App. 33a–34a. The Alaska Supreme Court therefore ignored that California's "hypothetical" choice between apportionment factors was dictated by the *Alaska* tax scheme. *See id.* Thus, it was Alaska's tax scheme, not some other state's taxing decisions, that caused Tesoro's "actual injury" of a risk of double taxation. *See id.* at 25a. In other words, "*this* state, Alaska, has treated [Tesoro] unfairly" by creating the risk of taxation on more than 100% of Tesoro's income. *See id.* at 35a.

The Alaska Supreme Court's holding that Tesoro did not suffer an "actual injury" from the internally inconsistent Alaska tax scheme, *see id.* at 34a, would lead to absurd results. Indeed, under that holding, Tesoro could be left without *any* redress for the risk of multiple taxation that Alaska has created. In fact, according to the Alaska Supreme Court, Tesoro could secure such redress only if *another* state *actually* imposed the same tax scheme as the Department, and Tesoro faced an increased tax burden in *that* state as a result. *See id.* at 25a–36a. Thus, Tesoro's ability to escape Alaska's unfair burdening of interstate commerce "would depend on the shifting complexities of the tax codes of 49 other States and . . . on the particular other States in which [Tesoro] operated," in contravention of this Court's construction of the internal-consistency requirement. *Armco*, 467 U.S. at 644–45.

C. The Court Should Address This Important And Recurring Question In This Case

The Alaska Supreme Court's grafting of an additional injury requirement onto the Court's

internal-consistency test destroys the nationwide consistency and constitutional protection that the internal-consistency test is designed to ensure. Indeed, the Alaska Supreme Court is the *only* court to date to have adopted this state-specific injury requirement, and did not cite any cases from any other jurisdiction to support it. *See* Pet. App. 25a–36a. This is understandable in view of *Armco*'s emphatic rejection of the argument that a taxpayer must prove "actual discriminatory impact" upon it to sustain an internal-consistency challenge. 467 U.S. at 644; *see supra* pp. 26–29. Thus, interstate taxpayers now face inconsistent legal regimes in an area where the Commerce Clause—and this Court's cases—guarantee a uniform nationwide standard.

Moreover, under the Alaska Supreme Court's decision, states are free to enact internally inconsistent tax regimes so long as the undisputed *risk* of multiple taxation does not lead to the *reality* of higher taxes in the taxing state. In other words, the Alaska decision allows states to reap the benefit of taxing interstate commerce without the burden of conforming their tax schemes to constitutional requirements.

This outcome would place multistate businesses like Tesoro in an intractable dilemma. Such businesses would be forced either to pay unconstitutional taxes in the face of exorbitant penalties, or to cease the very interstate operations that the Constitution and the internal-consistency requirement protect from state interference.

The Alaska Supreme Court's decision is merely the opening salvo on this recurring issue. According to a Westlaw search, no fewer than 102 state-court cases

have cited this Court's *Container Corp.* decision in the context of the internal-consistency requirement. Again that number does not encompass any unreported cases, or situations where taxpayers forego internal-consistency challenges or resolve them administratively. Thus, if left unreviewed, the Alaska Supreme Court's decision exposes interstate commerce to the burden of enormous potential taxes assessed under internally inconsistent and unconstitutional state tax schemes.

This case provides a perfect occasion for the Court to reemphasize its controlling construction of the internal-consistency test. Because it is undisputed that the Department's scheme as applied to Tesoro violated the internal-consistency requirement and the issue presents a pure question of law, this Court's decision would be dispositive on this issue. *See, e.g.*, *Oklahoma Tax Comm'n*, 514 U.S. at 185 ("A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax."). A decision from this Court also would restore uniformity in the application of that requirement and, thus, remove the substantial burden on interstate commerce and uncertainty to multistate enterprises like Tesoro sanctioned by the Alaska Supreme Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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