This Week in State Tax (TWIST)

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Michigan: Alternative Apportionment Denied and Use of Statutory Apportionment Formula was Constitutional

Recently, the Michigan Supreme Court issued a decision in seemingly never-ending litigation addressing whether and how amounts from the sale of a business should be included in the Michigan sales factor. This case has a long and complicated procedural history. The taxpayer, an S-corporation headquartered in Minnesota, was engaged in the business of constructing, maintaining, and repairing oil and gas pipelines. The taxpayer operated in 24 states, including periodically in Michigan, but never maintained a permanent business location or retained permanent employees in Michigan, which had historically resulted in relatively low Michigan sales. In the same year in which the taxpayer was cleaning up a catastrophic oil spill in Michigan (resulting in a significant increase in the taxpayer's Michigan sales), the taxpayer's shareholders sold all of their stock and elected under IRC § 338(h)(10) to treat the sale of stock as the taxpayer's sale of all of its assets. In computing its now-repealed Michigan Business Tax (MBT) liability on a short year return for the year of the sale, the taxpayer included the sale in its business income tax base; it also included the sale proceeds in the denominator of its sales factor. The proceeds were not included in the Michigan sales factor numerator. On audit, the Michigan Department of Treasury determined that the sale was not includable in the sales factor denominator under Michigan's statutory definition of "sales." This resulted in increasing the taxpayer's apportionment from about 15 percent to almost 70 percent because of its large project in Michigan during the tax year of the sale.

The taxpayer subsequently filed a complaint with the Court of Claims on multiple grounds, including arguing that it was entitled to use an alternative apportionment formula because to include the sale as business income while also excluding the asset sale from the sales factor would disproportionally attribute long-term gain to Michigan. The taxpayer also alleged that excluding the sale violated the Commerce and Due Process Clauses. The Court of Claims originally analyzed and decided the issue in favor of the Department. However, the appeals court reversed, holding that applying the statutory formula violated the Commerce Clause and an alternative should be applied. The Michigan Supreme Court vacated the Court of Appeals decision and remanded the matter back to the appeals court to determine the proper method of calculating MBT liability under the statutory apportionment formula. The Court of Appeals then remanded the matter to the Court of Claims, which ruled in Treasury's favor holding that that the sale of the taxpayer's business was not includable in the sales factor under the narrow statutory definition of a "sale." An appeal was filed, and the Court of Appeals agreed with the lower court that the amount was not included in the sales factor under the statutory definitions. However, the appeals court again held that the application of the statutory formula violated the constitution, and an alternative formula should be applied. The matter then went back up to the Michigan Supreme Court.

On appeal, the court considered two questions: (1) whether income from the sale should be included in the tax base; and (2) whether application of the statutory formula (excluding the sale from the sales factor denominator) would result in tax that was disproportionate to the taxpayer's business activities in Michigan.

The majority held that income from the sale was properly included in the apportionable tax base because the taxpayer was a member of a unitary business with Michigan nexus, the gain from the sale of all the taxpayer's assets was business income as defined in the statute, and the income was *not un*related to business activities in Michigan (which the majority identified as the relevant constitutional standard.) The majority also responded to an argument by the dissent that income from the sale could not be taxed in Michigan because it was attributable to assets held primarily outside of Michigan and goodwill accumulated primarily outside of Michigan; in the majority's view, although these assets had been historically used primarily outside of Michigan, there was no reason to believe that they would not be used in Michigan in the future.

The majority next addressed the taxpayer's argument that the application of the statutory apportionment formula, which excluded the sale from the sales factor denominator, resulted in attributing income to Michigan that was all out of proportion to the business transacted in the state. The taxpayer's argument appeared to focus on the fact that historically, it had significantly less Michigan activity. The court rejected the taxpayer's position and determined that the application of the statutory apportionment formula was constitutional under the Commerce Clause as applied to the taxpayer. The formula was internally consistent because application of the same rules by all states would result in tax on no more than 100 percent of the taxpayer's income. The majority also held that the formula was externally consistent. The taxpayer had not shown "by clear and cogent evidence" that the application of the statutory formula resulted in taxation of income that was out of all proportion to the taxpayer's business transacted in the state. In reaching this decision, the court pointed out that three-factor and single-factor methods often result in radically different apportionment ratios, and that states are nonetheless permitted to choose between them. It further observed that the statutory formula resulted in an outcome that accurately reflected the taxpayer's business activities within Michigan and that Michigan had no obligation to consider historical tax information when determining liability in the current year.

It is not known at this time whether the taxpayer will file a motion for reconsideration or rehearing with the Michigan Supreme Court or will seek an appeal to the U.S. Supreme Court. For questions on *Vectren Infrastructure Services Corp (Vectron II)* please contact Dan De Jong.

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