Michigan court upholds law retroactively rescinding Michigan's MTC membership

Overview

On September 29, 2015, the Michigan Court of Appeals in *Gillette Commercial Operations North America & Subsidiaries et. al. v. Department of Treasury* upheld a lower court decision that the enactment of Public Act 282 of 2014 (PA 282) retroactively rescinded Michigan's membership in the Multistate Tax Compact (Compact) effective January 1, 2008.[1] The Court of Appeals ruled that the enactment of PA 282 did not violate the state or federal Contract Clause, did not violate the state or federal Due Process Clause, did not violate the federal Commerce Clause and did not violate any procedural or substantive provisions of the Michigan Constitution.[2]

On this basis, the Michigan Court of Appeals ruled that Gillette Commercial Operations North America & Subsidiaries and the approximately three dozen other taxpayers who comprised the consolidated appeal could not elect to compute their Michigan Business Tax (MBT) liability for the affected tax years pursuant to the Compact's equally weighted, three-factor apportionment formula. Accordingly, the taxpayers were required to use the single sales factor apportionment formula as provided under the MBT Act pursuant to MCL § 208.1301(2).

The affected taxpayers have 42 days from the date of the Michigan Court of Appeals decision to file an application for leave to the Michigan Supreme Court, and the Michigan Supreme Court then has the discretion over whether to accept the case.[3] Accordingly, the case is not yet final.

This Tax Alert summarizes the Michigan Court of Appeals decision in *Gillette Commercial Operations North America & Subsidiaries et. al.* and provides related taxpayer considerations.

Background

The Compact, which became effective in 1967, was created by the states in response to federal proposals to regulate state taxation through the adoption of a uniform method of apportionment for state net income tax purposes. As part of the Compact, Article IV incorporates—almost verbatim—the provisions of the Uniform Division of Income for Tax Purposes Act, which provide for an equally weighted, three-factor apportionment formula. In addition, Article III of the Compact permits taxpayers to elect (Compact Election) to use the income apportionment provisions of Article IV in lieu of other income tax apportionment rules that may be adopted by the member states.

In 1969 Michigan enacted and codified the Compact, including Articles III and IV, in MCL § 205.581.[4] In 2007 Michigan adopted the MBT effective January 1, 2008, which provided for a single sales factor formula for purposes of apportioning both the Modified Gross Receipts Tax (MGRT) and the Business Income Tax (BIT) components of the MBT.[5] Prior to 2011, no explicit limitation existed on an MBT taxpayer's ability to apportion using the Compact election.[6]

On July 14, 2014, the Michigan Supreme Court in *International Business Machines v. Michigan Department of Treasury* held that the taxpayer could elect to compute both the BIT and MGRT components of its 2008 MBT liability using the Compact Election in lieu of the single sales factor apportionment formula under the MBT Act.[7] By application of the Compact Election, the taxpayer was allowed to use an equally weighted, three-factor (property, payroll and sales) apportionment formula.[8]

On September 11, 2014, Michigan Governor Snyder signed PA 282, repealing MCL §§ 205.581 to 205.589, the Compact provisions of Michigan law "[r]etroactively and effective beginning January 1, 2008".[9] On December 19, 2014, the Michigan Court of Claims granted the Michigan Department of Treasury (Treasury) motion for summary

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[1] *Gillette Commercial Operations North America & Subsidiaries et. al. v. Department of Treasury,* Michigan Court of Appeals (Published Decision, Sept. 29, 2015). A copy of the court's decision is available here.
[2] *Gillette Commercial Operations North America & Subsidiaries et. al.,* at 13.
[3] 7.305(C)(2) & 7.303(B)(1), Michigan Court Rules of 1985.
[4] Public Act 343 of 1969, effective July 1, 1970.
[5] Pbulic Act 36 of 2007, effective January 1, 2008. *See* MCL § 208.1301(2).
[6] In May 2011, Michigan amended Article III(1) of the Compact to provide that "[B]eginning January 1, 2011, … a taxpayer subject to the Michigan Business Tax Act … shall not apportion or allocate" in accordance with the Compact. Public Act 40 of 2011.
[7] *International Business Machines v. Michigan Department of Treasury*, 852 NW2d 865 (2014).
[8] The background, judicial history, and implications of the *IBM* decision were discussed in detail in the Deloitte Tax Alert dated July 16, 2014.
[9] Public Act 282 of 2014, repealing MCL §§ 205.581 to 589; signed by Governor Snyder on Sept. 11, 2014. The implications of PA 282 were summarized in the Deloitte Tax Alert dated September 12, 2014.

disposition and upheld the constitutionality of PA 282 in approximately three dozen cases originally filed between 2011 and 2015[10] involving taxpayers seeking MBT refunds by application of the Compact based equally-weighted, three-factor apportionment formula. Many of the affected taxpayers (taxpayers) appealed the matter to the Michigan Court of Appeals where the taxpayers' appeals were consolidated for consideration.

Michigan Court of Appeals decision—Retroactive repeal of Michigan's Compact provisions was a valid legislative act

In the consolidated appeal, the taxpayers argued that PA 282 did not repeal the Compact Election for various reasons, including, *inter alia*, that: the statute violated the Contract Clause of both the US and Michigan Constitutions, the statute violated the Due Process Clause of both the US and Michigan Constitutions, the statute violated the Separation of Powers Clause of the Michigan Constitution, and the statute violated the Commerce Clause of the US Constitution. The Michigan Court of Appeals addressed each of these arguments, consistently finding that PA 282's repeal of the Compact retroactive to January 1, 2008 did not violate the various provisions of the US and Michigan Constitutions.[11]

- **No Michigan or federal Contract Clause violation:** The Michigan Constitution provides that "[n]o … law impairing the obligation of contract shall be enacted."[12] Similarly, the Contract Clause of the US Constitution that provides: "[n]o State shall … pass any … Law impairing the Obligation of Contracts[.]"[13] The taxpayers argued that the Compact created a binding contract when adopted by Michigan in 1969, and therefore the enactment of PA 282 violated the Michigan and federal Contract Clause.

  In concluding that no contract was created under Michigan law through its adoption of the Compact, the Court of Appeals cited with agreement the opinion of the lower court, noting:

  > Because there is no clear indication under MCL 205.581 that the state contracted away its ability to either select an apportionment formula that differs from the Compact, or to repeal the Compact altogether, the Court concludes that no contractual obligation was created by enactment of 1969 PA 343 that would prohibit the enactment of [2014] PA 282.[14]

  The Court of Appeals also rejected the taxpayer's contention that the Compact created a binding contractual obligation under the federal Contract Clause noting the Compact's lack of a joint regulatory body, the autonomy of each Compact member state to operate its tax system independent of the other member states (i.e., no mandatory reciprocal action exists under the Compact) and that any member state could unilaterally withdraw from the Compact. Instead, as explained by the Michigan Court of Appeals, the Compact was "an *advisory agreement* that was agreed to by participating states as a means of addressing interstate business taxation and threatened federal intervention into that area. 2014 PA 282, which removed the state as a member of the Compact, was therefore not prohibited."[15] The Michigan Court of Appeals, citing the dissent in *IBM*, also noted that Compact member states' course of performance reinforced the conclusion that unilateral amendments or withdrawals had long been accepted "without objection" by other member states, factors weighing against the binding nature of any obligations under the Compact.[16]
- **No Michigan or federal Due Process Clause violation:** The Michigan Court of Appeals next addressed whether PA 282's retroactive repeal of the Compact violated the Due Process Clause of the Michigan and US Constitution, each guaranting that no state shall deprive any person of "life, liberty or property without due process of law."[17] The Michigan Court of Appeals began its due process analysis by noting that both federal and state courts have "uniformly held that retroactive modification of tax statutes does not offend due process considerations so long as there is a legitimate legislative purpose that furthered by a rational means"[18] and that

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[10] Most of the refund petitions were filed prior to the Michigan Supreme Court's resolution of *IBM*, and the cases were held in abeyance pending the outcome of that decision. It should also be noted that while IBM is a party to the appeal in *Gillette Commercial Operations North America & Subsidiaries et. al.,* its appeal from the 2008 tax year—which was the subject matter of *International Business Machines v. Michigan Department of Treasury*, 852 NW2d 865 (2014)—was not at issue in *Gillette Commercial Operations North America & Subsidiaries et. al.*

[11] The taxpayers also contended that the enactment of PA 282 violated their right to petition the government under the First Amendment of the US Constitution and the analogous Michigan provision. The Court of Appeals rejected this contention, commenting that "this very litigation demonstrates that [taxpayers] have had an ample opportunity to present their arguments to the courts." *Gillette Commercial Operations North America & Subsidiaries et. al.,* at 34.

[12] *Id.* at 18, citing, Michigan Const. 1963, Art. I, § 10.

[13] *Id.*, citing US Const., Art I, § 10.

[14] *Id*. at 19.

[15] *Id*. at 21 (emphasis added).

[16] *Id*.

[17] *Id.* at 22, citing US Const., Am. 14, and Michigan Const. 1963, Art. I, § 17

[18] *Gillette Commercial Operations North America & Subsidiaries et. al.*, at 22. Citing *United States v. Carlton,* 512 US 26 (1994), the Michigan Court of Appeals also noted that a taxpayer's reliance on a view of a law, "even a correct view of the law," does not prevent the legislature from retroactively amending a law. *Id.* at 23.

the existence of a vested right is necessary to establish a Due Process violation.[19] Noting prior Michigan jurisprudence relative to retroactive tax law changes, the Michigan Court of Appeals reiterated that to be vested, "a right must be more than a mere expectation based on the anticipated continuance of the present laws."[20] Construing the taxpayer's claims for refunds based on the *IBM* decision in a similar light, the Michigan Court of Appeals rejected the taxpayers' contention that the "continuation of the Compact's apportionment provision" rose to a vested right. [21]

Relative to the issue of whether the Michigan legislature had a legitimate purpose to give retroactive effect to PA 282, the Michigan Court of Appeals held that this was satisfied based on the stated legislative goal of preventing a significant revenue loss associated with Compact-based revenue claims as well as the legislative motivation to correct a perceived misinterpretation of the application of the Compact provisions of Michigan law.[22] In reaching its ultimate conclusion that no Due Process violation occurred, the Michigan Court of Appeals also determined that retroactive application of PA 282 was a rational means to further these legitimate purposes. Significant to this conclusion was the Court of Appeal's determination that "no doubt" existed that the Michigan Legislature acted promptly to correct its error (measured relative to the July 2014 decision of the Michigan Supreme Court in *IBM*) and that the "six and one-half year retroactive period was sufficiently modest relative to time frames of other retroactive legislation that have been upheld by Michigan courts, federal courts, and other state courts."[23]

The Michigan Court of Appeals also addressed a significant contention of the taxpayers that Michigan's participation "under the Compact in the period from 2008 through 2010 by paying dues, voting, participating in Commission leadership and meetings, and exchanging confidential taxpayer information" made the possibility for retroactive withdrawal "nonsensical."[24] The Court of Appeals rejected the taxpayers' argument, stating that taxpayers "failed to provide any law establishing the relevancy of such evidence, and since the statutory and constitutional issues raised are legal issues … we fail to see how Michigan's participation in the Commission impacts the legal import of the statute."[25]

- **No Separation of Powers Clause violation of the Michigan Constitution:**[26] The Michigan Court of Appeals then turned to taxpayers' argument that the retroactive application of PA 282 violated the Separation of Powers Clause of the Michigan Constitution. While this provision of the Michigan Constitution prevents the Michigan Legislature from enacting a law that "reverse[s] a judicial decision or … repeal[s] a final judgement," the Michigan Court of Appeals contrasted this with the permissible authority of the Michigan legislature to "amend a statute that it believes has been misconstrued by the judiciary."[27] Noting the Michigan Supreme Court holding in *IBM* that the 2007 enactment of the MBT did not *implicitly* repeal the Compact election, the Michigan Court of Appeals held that PA 282 did not overturn the *IBM* decision. In the opinion of the Michigan Court of Appeals, PA 282 merely enacted a new law "not interpreted by the *IBM* Court" that *explicitly* repealed the Compact provisions effective January 1, 2008. Expanding on this logic, the Michigan Court of Appeals stated that "[a]lthough 2014 PA 282 may have rendered moot the effect of the judicial interpretation in *IBM*, this did not overturn that Court's judgment and did not violate the separation of powers doctrine."[28]
- **No federal Commerce Clause violation:** The Michigan Court of Appeals also considered the taxpayers' contention that PA 282 was a violation of the Commerce Clause of the US Constitution, notably its dormant or "negative sweep" element which "prohibit[s] certain state actions that interfere with interstate commerce."[29]

  Noting the four-prong test established in *Complete Auto Transit, Inc. v. Brady*,[30] for determining whether a state law violates the Commerce Clause, the Michigan Court of Appeals focused its analysis on the third prong of the *Complete Auto Transit* test, specifically whether PA 282 discriminated against interstate commerce. The

[19] *Id.* at 24.
[20] *Id*.
[21] *Id*. at 25.
[22] *Id*. at 26.
[23] *Id*.
[24] *Id*. at 27.
[25] *Id*. at 27.
[26] The taxpayers also contended that PA 282 violated various other provision of the Michigan Constitution including the Title-Object Clause and the Distinct-Statement Clause generally intended to ensure that both legislators and the public have proper notice of legislative content and to avoid deceptive legislation. Noting that the repeal of the Compact provisions was pertinent to the proper method of apportionment of the MBT tax base, the Court of Appeals held that neither the lack of word "Compact" in the title of PA 282 nor the expressed general purpose of amending the MBT Act along with the reference to "repeal of acts and parts of other acts" in the title of PA 282 violated these provisions of the Michigan constitution. *Gillette Commercial Operations North America & Subsidiaries et. al.,* at 34-38.
[27] *Id*. at 28.
[28] *Id*. at 29.
[29] *Id*. at 30, citing *Quill Corp. v. North Dakota,* 504 US 298, 309 (1992.)
[30] 430 US 279 (1977).

Michigan Court of Appeals initially rejected the taxpayers' contention that PA 282 provided a benefit to local businesses that was otherwise denied to out-of-state businesses, finding that PA 282 "puts in and out of state corporate taxpayers *in the same position* relative to Michigan tax calculations."[31] The Michigan Court of Appeals also rejected the taxpayers' contention that a discriminatory purpose could be drawn from public comments made by legislators (relative to out-of-state taxpayers) during the process of enacting PA 282, holding that "the purported media comments of the legislators do not reveal any intent to discriminate against interstate commerce but, instead, are reasonably understood to reflect a desire to ensure a *level playing field* and to avoid giving an unfair advantage to out-of-state businesses.[32]

In concluding that PA 282 gave rise to no interstate discrimination, the Michigan Court of Appeals also took note of the fact that a single sales factor apportionment formula—previously found to be constitutionally permissible by the US Supreme Court in *Moorman MFG. Co. v. Bair*[33] relative to Iowa's use of a single sales factor apportionment—treats "local and foreign companies with an equal hand by requiring the single-factor formula for both."[34]

Ultimately, the Michigan Court of Appeals did not sustain any of the arguments made by the taxpayers and upheld the lower court's dismissal of the taxpayers' MBT refund claims.

Considerations

As of the release date of this Tax Alert and as noted previously, the period for filing an application for leave to the Michigan Supreme Court remains open. Accordingly, the case is not yet final.

To date, numerous taxpayers not otherwise parties to the appeal in *Gillette Commercial Operations North America & Subsidiaries et. al.* have challenged Treasury's disallowance of the Compact Election on previously filed MBT returns. These taxpayers likely have requested an Informal Conference at the administrative hearing level or pursued an appeal before the Michigan Tax Tribunal.[35] In most instances, these protests or appeals have been held in abeyance. While it is unclear whether Treasury will seek to move these matters to some sort of unfavorable resolution as a result of the Michigan Court of Appeals decision in *Gillette Commercial Operations North America et. al.*, the likelihood of further appeal by some or all of the affected taxpayers in the decision suggests that any Treasury action on pending protests or appeals would be premature.

Contacts

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[31] *Id*. at 31. (Italicized emphasis from original court decision.)
[32] *Id.* (Italicized emphasis from original court decision.)
[33] 437 US 267 (1978).
[34] *Id*. at 32.
[35] The possibility exists that additional Compact-based refund claims have been filed with the Michigan Court of Claims subsequent to its decisions in December 2014 which became the subject matter of the consolidated appeals heard by the Court of Appeals in *Gillette Commercial Operations North America & Subsidiaries et. al*.