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Multistate Tax
EXTERNAL ALERT

# Michigan Supreme Court Upholds "Compact" Equally-weighted, Three-factor Apportionment Election for MBT Purposes for 2008 and Characterizes Modified Gross Receipts Tax Component of MBT as an Income Tax

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## Overview

On July 14, 2014, a four justice majority of the Michigan Supreme Court in *International Business Machines v. Michigan Department of Treasury* ("*IBM*") reversed an earlier Michigan Court of Appeals decision and held that the enactment of the Michigan Business Tax Act ("MBT Act") did not "repeal by implication" the election provision of the Multistate Tax Compact ("Compact") codified in the Michigan Revenue Act, MCL Section 205.581, Article III(1). Therefore, the court held that the taxpayer could elect to compute its Michigan Business Tax ("MBT") liability for the 2008 tax year pursuant to the equally-weighted, three-factor apportionment formula (property, payroll and sales) provided by Article III of the Compact ("Compact election") in lieu of the 100% sales-weighted apportionment formula under the MBT Act. The court also held that the Modified Gross Receipts Tax ("MGRT") component of the MBT fit the Compact's broad definition of an "income tax" and therefore the taxpayer could elect to apply the Compact's equally-weighted, three-factor formula in computing the MGRT in addition to the Business Income Tax ("BIT") component of the MBT.[1]

In this Tax Alert we summarize the Michigan Supreme Court's decision in *IBM* and provide 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 apportioning state net income taxes. Among the Compact's provisions, Article IV incorporates, almost verbatim, the provisions of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which provides for an equally-weighted, three-factor formula. Also, Article III of the Compact permits taxpayers to elect 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.[2] In 2007 Michigan adopted the MBT Act, enacting the MBT effective January 1, 2008, which provided for a 100% sales-weighted apportionment formula for purposes of apportioning both the BIT and MGRT bases of the MBT.[3] Prior to 2011, no explicit limitation existed on an MBT taxpayer's ability to apportion using the Compact election.[4]

In the matter before the court in *IBM*, the taxpayer had filed its original 2008 MBT return utilizing the Compact election to apportion both the BIT and MGRT bases of its MBT. The Michigan Department of Treasury ("Treasury") denied the taxpayer's Compact election and recomputed the MBT liability by applying a 100% sales-weighted apportionment formula to both bases. The taxpayer challenged Treasury's adjustments and computations, and litigation ensued. The Michigan Court of Claims granted summary disposition to Treasury in an unpublished bench opinion issued on July 20, 2011.[5]

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[1] *IBM v. Michigan Department of Treasury* Mich. Supreme Court Docket No. 146440 (July 14, 2014). A copy of this decision is accessible at: **http://publicdocs.courts.mi.gov:81/opinions/final/sct/20140714_s146440_129_01_ibm-op.pdf**.
[2] PA 343 of 1969, effective July 1, 1970.
[3] PA 36 of 2007, effective January 1, 2008. *See*, MCL § 208.1301(2).
[4] In May of 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.
[5] See *IBM v. Michigan Department of Treasury*, Michigan Court of Claims File, No. 11-33-MT, July 20, 2011 (unpublished).

## Michigan Court of Appeals Decision

A two-judge majority held in an unpublished Court of Appeals opinion issued on November 20, 2012, that the taxpayer was required to compute its MBT liability pursuant to the MBT Act's 100% sales-weighted apportionment formula and was not permitted to apportion pursuant to the equally-weighted, three-factor apportionment formula provided by the Compact election.[6]

In finding for Treasury, the Michigan Court of Appeals stated that the MBT Act and the Compact cannot be harmonized and are in "irreconcilable conflict." In light of this purported conflict (and without analysis of the history of the Compact or its goal to promote uniformity), the Court of Appeals concluded that the later-enacted MBT statutory provision "repeals by implication" the election provisions in the Compact.[7]

## Michigan Supreme Court Decision – Compact Election Is Available

In the lead opinion written by Justice Viviano (joined by two other justices), the Michigan Supreme Court first considered whether the Michigan Legislature "repealed by implication" the Compact's election provision (enacted in MCL § 205.581 in 1969) when the Legislature subsequently enacted the MBT Act in 2007. In this context, the court cited various common law principles associated with the implied repeal doctrine, stating "it is our duty to proceed on the assumption that the Legislature desired both statutes to continue in effect unless it manifestly appears that such view is not reasonably plausible."[8] In its decision, the court noted a number of factors in assessing the Legislature's intent in this regard, including:

- The continued and unaltered existence of the Compact election provisions pursuant to MCL § 205.581 during the migration from the Michigan Corporate Income Tax of 1967 to the Michigan Single Business Tax (in 1976) and the subsequent migration from the Michigan Single Business Tax to the MBT (in 2007).[9]
- The May 25, 2011, legislative amendment arising from the enactment of P.A. 40 of 2011, which expressly repealed the Compact election provision "beginning January 1, 2011."[10]

Stating that the "express repeal of the Compact's election provision effective January 1, 2011, is evidence that the Legislature had not impliedly repealed the provision when it enacted the [MBT Act]," the Michigan Supreme Court concluded that "the Compact's election provision remained in effect for the 2008 tax year."[11]

The Michigan Supreme Court lead opinion ultimately held that the Compact election and the apportionment provisions of the MBT Act "are compatible and can be read as a harmonious whole" and such an interpretation "allows the Compact's election provision to serve its purpose of providing uniformity to multistate taxpayers in light of Michigan's enactment of an apportionment formula different from the Compact's formula."[12]

In a concurring opinion, Justice Zahra concluded that even if the Legislature had implicitly repealed the Compact election by virtue of its enactment of the MBT Act, the Legislature's subsequent amendment to the Compact provisions through the enactment of P.A. 40 of 2011 should be construed as having "reenacted" all of the provisions of the Compact for all periods prior to the January 1, 2011 repeal date.[13]

## Michigan Supreme Court Decision – Compact Election Extends to Modified Gross Receipts Tax

With the existence of the Compact election validated for purposes of the taxpayer's 2008 MBT tax year,[14] the Michigan Supreme Court lead opinion then considered whether the MGRT component of the MBT is an "income tax" under the Compact and thus apportionable pursuant to the equally-weighted, three-factor apportionment

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[6] *IBM v. Michigan Department of Treasury*, Michigan Court of Appeals (Unpublished Per Curiam Decision, Docket No. 306618. November 20, 2012).
[7] For a summary of the Michigan Court of Appeals' *IBM* decision, please see our External Tax Alert dated November 26, 2012, accessible at:
**https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_multistate_MI_alert_112712.pdf.**
[8] *IBM v. Michigan Department of Treasury* Mich. Supreme Court Docket No. 146440 (July 14, 2014), at 9.
[9] *Id*. at 6, 14.
[10] *Id*. at 16-17.
[11] *Id*. at 17.
[12] *Id*. at 19. Because the lead opinion was able to "harmonize the statutes and conclude that no repeal by implication occurred," no analysis was necessary of the binding interstate nature of the Compact and whether Michigan even could repeal the Compact. *Id*. at 20, n.67.
[13] *Id*. at 1-2 (Zahra, J., concurring).
[14] While the lead opinion only explicitly references the "2008 tax year" in its holding, the statutory relationship between the MBT Act and the Compact election is unchanged through December 31, 2010.

formula of the Compact.[15] Citing the Compact definition of an "income tax" provided in MCL Section 205.581, Article II(4), the court stated that "for the MGRT to be an income tax under the Compact, a tax must measure net income by starting with gross income and subtracting expenses, with at least one of the expense deductions not specifically and directly related to a particular transaction."[16]

The Michigan Supreme Court considered both the Internal Revenue Code and Black's Law Dictionary definitions of "gross income" and determined that both definitions are similar to the definition of "gross receipts" under MCL § 208.1111(1) of the MBT Act, the starting point for the MGRT tax base.[17] The court also determined that the various statutory deductions from the MGRT tax base provided for "purchases from other firms" under MCL § 208.1113(6) (notably the purchase of inventory, depreciable assets and materials and supplies) are consistent with a cost of goods sold concept (in the case of inventory purchased) and are not specifically tied nor directly related to particular transactions (in the case of all three categories of purchase deductions from the MGRT tax base).[18] Ultimately, the court in its lead opinion held:

> [T]he MGRT fits within the broad definition of "income tax" under the Compact by taxing a variation of net income – the entire amount received by the taxpayer as determined from any gainful activity minus inventory and certain other deductions that are expenses not specifically and directly related to particular transactions.[19]

## Dissenting Opinion

In a dissenting opinion written by Justice McCormack, (joined by two other justices including the Chief Justice), the dissent disagreed with the lead opinion's holding, contending that MBT Act and the Compact election provisions cannot be read harmoniously.[20] As reasoned in the dissenting opinion, an irreconcilable conflict exists because the "mandatory" 100% sales-weighed formula of the MBT Act is otherwise converted into an "optional" provision by operation of the Compact election.[21] On this basis, the dissent argued that the doctrine of implied repeal would apply and would thus resolve the conflict in favor of the later-enacted MBT provision.[22]

## Considerations

It is conceivable that Treasury will file a motion for reconsideration with the Michigan Supreme Court and, if unsuccessful, subsequently a Writ for Certiorari with the United States Supreme Court.

Taxpayers that have previously filed MBT returns for 2008 through 2010 seeking to make the Compact election have likely received notices from Treasury disallowing that election and have had their MBT liability recomputed based on a 100% sales-weighted apportionment formula. For those taxpayers that have timely protested these notices (e.g., through a request for an Informal Conference per MCL § 205.21(2)(b)), it is presently unclear how the Michigan Supreme Court decision will affect these pending protests, though a communication from Treasury may potentially be forthcoming in this regard.

Taxpayers that have not previously filed MBT returns seeking to apply the Compact election should carefully consider whether the filing of an amended MBT return is merited in light of the Michigan Supreme Court's decision, taking into account the applicable statute of limitations.[23]

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[15] No dispute existed as to the characterization of the BIT as an "income tax" under the Compact. *See*, *Id*. at 20.
[16] *Id*. at 23.
[17] *Id*. at 24.
[18] *Id*. at 24-25.
[19] *Id*. at 25.
[20] In his concurring opinion, Justice Zahra noted his agreement with the lead opinion "that the tax bases at issue here are 'income taxes' within the meaning of the Compact." *Id*. at 1 (Zahra, J., concurring). The dissent provides no commentary regarding the "income tax" nature of the MGRT element of the MBT.
[21] *Id*. at 4 (McCormack, J., dissenting). Noting that the dissent "spends very little time considering the language of the Compact, its history, or the history of business taxation in Michigan," the lead opinion rejects the dissent's finding of implied repeal because of the dissent's failure to make "every attempt" to construe the MBT Act and the Compact harmoniously. *Id*. at 17.
[22] While outside the scope of this Alert, the dissent also would have rejected taxpayer's arguments (premised on federal compact law and the Contract Clause of the U.S. Constitution) that the Compact is a valid enforceable interstate compact that precludes a legislative repeal of the Compact election provisions so long as the state remains a member of the Compact. *Id*. at 7-14 (McCormack, J., dissenting). While ultimately of no bearing on the outcome of the *IBM* decision, the dissent's analysis may be of interest in other Compact member states that have expressly repealed the Compact election.
[23] The statute of limitations for taxpayers seeking to file amended Michigan tax returns is generally four years from the properly extended due date of the original return. MCL § 205.27a(2).

## Contacts

If you have questions regarding the *IBM* decision or other Michigan tax matters, please contact any of the following Deloitte Tax professionals.


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