

# The Rise and Fall of the Michigan Single Business Tax

*By Gregory A. Nowak, Janelle C. Punch and Rebecca M. Pritchard*

Michigan enacted Public Act 228, the Single Business Tax (SBT) Act on January 1, 1976, replacing seven existing taxes, including the corporate income tax and personal property tax on inventory. Thirty years ago, the primary motivation driving the bold experiment of the SBT was the desire to reduce dramatic fluctuations in revenue directly related to the business cycle. The hope was to guarantee a stable source of revenue resistant to the volatility of Michigan's auto dependent economy through the nation's first value added tax. The SBT was also enacted to "level the playing field" amongst taxpayers. No longer would an entity be taxed solely because it was profitable. In addition, by consolidating seven different taxes, the SBT was designed to simplify and reduce the cost of business tax preparation and processing within the Michigan Department of Treasury.

Despite all of the optimism surrounding the promising SBT upon its enactment 30 years ago, Michigan business taxpayers never really warmed up to the tax, and no state chose to follow in Michigan's footsteps. After a long history of legal battles, and steadily growing discontent among Michigan taxpayers, the Michigan legislature is bringing an end to the great value added tax experiment by repealing the SBT effective December 31, 2007. This article will provide an overview of the SBT, review the history of conflicts concerning the tax, outline the events leading to its repeal, and describe some of the potential alternatives tax structures that could replace it.

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## Overview of the SBT

The SBT is the only tax of its kind and is levied and imposed on the privilege of conducting business activity in Michigan, not on income, and is therefore referred to as a "value-added" tax. Every corporate and noncorporate entity with business activity in Michigan may be subject to the SBT including individuals, professional corporations, limited liability companies, fiduciaries, S corporations and partnerships.<sup>1</sup>

An entity whose apportioned or allocated gross receipts plus capital acquisition recapture is greater than \$350,000 must file an SBT return. Michigan conforms to the federal check-the-box regulations for SBT purposes. A taxpayer who elects entity classification at the federal level must file a Michigan SBT return on the same basis. If a single-member unincorporated entity is disregarded as an entity separate from its owner at the federal level it is treated as a branch, division, or sole proprietorship for SBT purposes. A business is subject to the SBT if it has nexus under the Due Process and Commerce Clauses of the U.S. Constitution and is conducting a taxable business activity in-state. The Michigan Court of Appeals held that P.L. 86-272 does not apply to the SBT as it is not an income tax.<sup>2</sup>

The starting point for computing the SBT tax base is "business income." For corporations, business income is federal taxable income (FTI), or line 30 of Federal Form 1120. For noncorporate entities (e.g., partnerships), "business income" means that part of federal taxable income derived from business activity. The base also includes several significant modifications. These include the addition of compensation and depreciation, subtraction of royalty and interest income, and the addition of royalty and interest expense.

Michigan law requires compensation to be added to business income. Note that this addback is not limited to the amount of compensation deducted in computing FTI, but rather includes total compensation. Compensation includes salaries and wages, employee insurance plans, pension, retirement, profit sharing plans and other compensation payments.

A deduction claimed on the federal return for depreciation, amortization or immediate or accelerated write-off related to the cost of tangible assets, including depreciation in cost of goods sold, must also be added back to federal taxable income when determining the SBT base.

Royalty and interest income included in federal taxable income must be subtracted in determining the SBT base. Royalties and interest paid that were claimed as a deduction on the federal return must be added back in determining the SBT base. Interest income from obligations or securities of states other than Michigan must be added back to FTI. Note that companies qualifying as financial organizations are not required to add back interest paid or subtract interest received.

Other additions to the tax base include (to the extent they are deducted in calculating FTI) state, local and foreign income taxes as well as SBT paid, dividends paid or accrued, federal net operating loss carryovers or carrybacks, capital loss carryovers or carrybacks, losses attributable to business entities that are subject to the SBT or would be subject to the SBT if their business activities were conducted in the state (e.g., distributive partnership income, distributive S corporation income) and royalty expenses.

Other subtractions include dividends received or considered received, including the foreign dividends gross-up provided for in the Internal Revenue Code, gains attributable to business entities that are subject to the SBT or would be subject to the SBT if their business activities were conducted in the state (e.g., distributive partnership income, distributive S corporation income), capital losses sustained during the tax year that were not deducted in arriving at federal taxable income and royalty income.

Michigan applies a three-factor apportionment formula to the tax base. The formula is the sum of the property factor multiplied by five percent, the payroll

factor multiplied by five percent, and the sales factor multiplied by 90 percent. For tax years 2006 and 2007, the property and payroll factors are weighted 3.75 percent each and the sales factor is weighted 92.5 percent. For tax years after 2007, the property and payroll factors are weighted 2.5 percent each and the sales factor is weighted 95 percent. Special provisions apply to transportation companies, financial organizations and insurers.

Michigan provides several different credits to taxpayers. The investment tax credit (ITC) provides a credit for expenditures on tangible property eligible for depreciation or amortization. The ITC is a non-refundable credit that may be carried forward for a maximum of nine years. Note that taxpayers that

reduce their adjusted tax based by the gross receipts reduction (discussed below) are not eligible for the ITC. During the 2000 tax year, the ITC replaced the capital acquisition deduction (CAD), which was similar to the ITC. Recapture of the ITC (and/or CAD) is required when

qualifying tangible assets are sold, exchanged or disposed of. The recapture amount varies depending on whether the asset is a tangible asset located in Michigan, a mobile asset or a tangible asset transferred from Michigan.

Other credits include the Renaissance Zone credit, research and development credit, job creation hiring-MEGA credits, unincorporated S corporation credit and the environmental, economic development, historic property and investment in small business credits. The Renaissance Zone credit is available to a business located and conducting business activity in a renaissance zone based on the tax liability attributable to the business activity. A MEGA business activity credit may be claimed by an authorized business certified under the MEGA Act. The credit should not exceed 20 years plus any carryforward years. An unincorporated S corporation credit is allowed for a portion of a taxpayer's SBT liability varying upon the taxpayer's business income. Taxpayers whose gross receipts do not exceed \$10 million and whose adjusted business income minus the loss adjustment do not exceed \$475,000 are eligible for an investment in small business credit.

Additional reductions are allowed to the adjusted tax base including the compensation reduction and

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the gross receipts reduction. The compensation reduction is utilized by labor intensive companies, and is a fairly convoluted calculation. If a taxpayer's total compensation paid exceeds 63 percent of the pre-apportioned tax base, the taxpayer may elect to reduce the adjusted tax base by the percentage by which the compensation divided by the unapportioned tax base exceeds 63 percent. The reduction cannot exceed 37 percent of the adjusted tax base and may be taken only if the gross receipts reduction is not taken for the same tax year. The gross receipts reduction is an alternative method to compute the SBT. The computation of the tax is based on the taxpayer's "adjusted gross receipts." Adjusted gross receipts means gross receipts plus recapture of the capital acquisition deduction. Under this method, the taxpayer's tax base can be no greater than 50 percent of the apportioned gross receipts plus capital acquisition deduction recapture. This method ignores the typical addition and subtraction modifications to arrive at the tax base.

Michigan allows, and may require in some instances, taxpayers to file a consolidated return if certain criteria are met. A request to file a consolidated or combined return must be received by the Department of Revenue prior to the date set for filing an SBT return. If a business receives the State Treasurer's approval, a consolidated or combined SBT return may be filed. However, the Michigan combined group is not identical to the federal consolidated group. Several conditions must be met in order to file a consolidated SBT return. The parent must be a member of the consolidated group and each member of the group must be subject to the SBT. In addition, each member must have substantial intercorporate transactions with one or more members of the group, and must utilize the same apportionment formula. "Intercorporate transactions" are sales generating gross receipts, but do not include functions of control involving accounting, legal or personnel matters or transactions concerning ownership or financing arrangements. Intercorporate transactions are considered "substantial" if receipts from intercorporate transactions are at least 10 percent of total receipts, or if intercorporate purchases are at least 10 percent of total purchases. If this 10-percent threshold is

not met, the affiliated group must demonstrate that the intercorporate transactions are of a "substantial" nature. If a consolidated return is allowed, the affiliated group is treated as one corporation for apportionment purposes, and intercorporate sales and rent are eliminated when computing the sales and property factor.

## **Fraught with Controversy**

During the years following the enactment of the SBT in 1975, it was subject to seemingly continuous challenge. Being the only value-added tax in the country, there was no established case law in other states concerning the various unique elements of the tax. While the various controversies which surrounded the SBT were all ultimately resolved, these challenges

served to undermine confidence in the SBT, and helped earn it a reputation as a complex and problematic tax.

The first major challenge began in the early 1980s, when taxpayers argued that the inclusion of compensation paid outside of Michigan should not be

**Throughout its lifespan, the SBT has been described in many ways. At its onset, it was considered a viable revenue-producing source; at its demise, overly burdensome and complex.**

includible in the "value added" tax base in the SBT calculation and apportioned to Michigan, since it represented value added outside of the state of Michigan. The taxpayers argued that the SBT violated the fair apportionment and discrimination prongs of the Commerce Clause, and that a relief provision of the SBT required the alternate apportionment method of including only Michigan compensation. The appellate courts in Michigan initially agreed with the taxpayers,<sup>3</sup> resulting in virtually every major taxpayer in Michigan filing claims for refund. The legislature subsequently changed the statute to narrow the application of the relief provision,<sup>4</sup> and the Michigan Supreme Court ultimately ruled that the statute was valid and that taxpayers were not entitled to relief.<sup>5</sup> However, the U.S. Supreme Court granted Certiorari in the case, and thus the controversy continued until the U.S. Supreme Court rendered a decision in 1991.<sup>6</sup> That decision upheld the SBT, finding that it was fairly apportioned since it was an indivisible tax on value added, and not a series of separate taxes imposed on the components of the tax base.<sup>7</sup> In total it took almost a decade to resolve this first fundamental attack on the SBT.

The next major attack on the SBT was initiated before the controversy in *Trinova* had even been resolved. In *Caterpillar*,<sup>8</sup> the Michigan Court of Claims held that the capital acquisition deduction (CAD) provisions of the SBT were discriminatory, since they provided for deductions based on real property physically located in Michigan and personal property apportioned based on the ratio of Michigan property and payroll to total property and payroll, while the tax base was apportioned based on a three-factor formula consisting of property, payroll and sales. The trial court originally severed the CAD provisions from the act entirely, but the Michigan court of appeals<sup>9</sup> subsequently held that the proper remedy was to allow a CAD deduction without apportionment. Motivated in part by a short 90-day statute of limitations that applies to constitutional challenges to Michigan taxes,<sup>10</sup> taxpayers filed more than 550 refund claims totaling more than \$560M.<sup>11</sup> The legislature responded to the fiscal uncertainty created by this litigation by amending the CAD to provide for a deduction apportioned in the same manner as the tax base is apportioned. The intent of this legislation was to prescribe a remedy which would not only apply prospectively, but would be the retrospective remedy in the event the constitutional challenge to the CAD was ultimately sustained. This “protective” amendment proved to be unnecessary, since in 1992 the Michigan Supreme Court reversed the Court of Appeals and held that the CAD apportionment provisions were constitutional.<sup>12</sup> However, the modification of the CAD apportionment remained in the law until 1995.

Shortly after *Caterpillar* was resolved, another broad challenge to an element of the SBT was brought. In *Thiokol Corp.*,<sup>13</sup> it was argued that the SBT violated federal law (ERISA) by including employee benefit contributions within the SBT tax base. This challenge asserted that ERISA pre-empted federal law, and accordingly this challenge was brought in federal court. The Federal District Court upheld federal court jurisdiction over this state tax issue despite the Federal Tax Anti-Injunction Act,<sup>14</sup> and in 1994 ruled in favor of the taxpayer in that case, and more than 212 refund claims totaling more than \$142M were filed. Ultimately the Sixth Circuit Court of Appeals reversed in 1996 and held in favor of the Department, and the U.S. Supreme Court in 1997 denied certiorari.<sup>15</sup> While the two challenges in *Trinova* and *Caterpillar* the claims for refund regarding the *Thiokol* issue were ultimately dismissed, the SBT had suffered yet another blow to its already beleaguered reputation. Fundamental uncertainty

about the validity of the tax had continued more than 20 years after its original enactment.

After a few years of relative calm, another CAD challenge was raised in connection with 1995 amendments to the CAD which limited the CAD to investments in Michigan multiplied by the Michigan apportionment percentage for years 1997 through 1999. In 1999 the Michigan Court of Claims in *Jefferson Smurfit* held that limiting the apportioned CAD to Michigan property discriminated against interstate commerce.<sup>16</sup> This led to yet another round of refund claims by numerous taxpayers, as well as legislation that repealed the CAD and replaced it with an investment tax credit for years beginning in 2000. In 2001 the Michigan Court of Appeals reversed the Court of Claims decision in *Jefferson Smurfit*, holding that the earlier *Caterpillar* case which had upheld a CAD deduction for Michigan property only was controlling.<sup>17</sup> The Court in this decision largely ignored the distinction that the 1997–1999 deduction was also apportioned, while the earlier CAD provision at issue in *Caterpillar* was not. In 2002 the Michigan Supreme Court denied review of the decision, and in 2003 the U.S. Supreme Court also denied review.

Four more years of constitutional uncertainty had transpired as a result of the *Jefferson Smurfit* litigation, and while the Department of Treasury in 2003 believed that this challenge was at last behind them, yet another challenge surfaced in 2004 in *Dana Corp.* This challenge was based on the argument that the Michigan Court of Appeals had failed to address the argument that the CAD violated the internal consistency requirement to be fairly apportioned under the Commerce Clause. The Court of Claims again held in favor of the taxpayer,<sup>18</sup> distinguishing the decision in *Jefferson Smurfit*, and another appeal was brought by the Department to the Court of Appeals. The Court of Appeals reversed the decision of the Court of Claims in 2005,<sup>19</sup> finding that the *Jefferson Smurfit* and *Caterpillar* decisions were controlling, and the Michigan Supreme Court denied leave to appeal in 2006.<sup>20</sup> In total, these cases kept a cloud of uncertainty over the SBT for another seven years, right up until the year in which the legislature finally acted to repeal the SBT effective at the end of 2007.

And these were not the only challenges brought to the SBT over the years. The question of whether the SBT was subject to the limitations of P.L. 86-272 was raised in the cases of *Gillette* and *Guardian Industries* in the early 1990s. *Gillette* involved both the standard for imposition of the SBT and *Guardian*

involved the standard to be applied to a taxpayer's activity in another state for purposes of avoiding the throwback of sales in the Michigan sales factor. The Department was arguing in both cases that P.L. 86-272 was the proper standard for both purposes, but the appellate courts held that P.L. 86-272 did not apply to the SBT, and the SBT was limited only by the constitutional limits of the Commerce Clause.<sup>21</sup> Other cases followed addressing whether the activities of independent sales representatives would be attributed to the taxpayer, since the Department initially sought to apply these decisions narrowly only to the activities of employees. Ultimately the Department conceded that the activities of independent representatives create nexus, but the Department's policy position which implemented these 1993 Court of Appeals decisions was not issued until 1998. In its 1998 guidance the Department stated that the decisions would be applied retroactively to 1989, four years prior to the issuance date of those decisions, based on Michigan's four year statute of limitations.<sup>22</sup>

Other cases over the years addressed other fundamental questions including what constitutes a "royalty"<sup>23</sup> or "interest"<sup>24</sup> neither of which is either taxable or deductible for SBT purposes, and what constitutes a "casual transaction,"<sup>25</sup> the income from which is excludible from the SBT base.

In addition to the legal controversies plaguing the SBT, criticism of the tax is rampant among businesses, politicians, and analysts. The most common complaint surrounding the tax focuses on the complexity of the tax laws enacted over the past 15 years or so. What began as a simplified tax designed to eliminate confusion has snowballed into an increasingly intricate system that is extremely difficult to understand, compute and even audit. As a result, compliance costs have significantly increased. Further criticisms center around the lack of sensitivity of the tax to the ability to pay. Because the tax requires substantial addbacks such as compensation and depreciation, taxpayers may find themselves paying tax despite the fact that they are in a loss position. The \$350,000 filing threshold also presents an issue. A taxpayer can very easily move from zero tax liability to a substantial tax liability if it crosses the threshold from one year to the next. There has also been criticism related to special provisions in the SBT Act. For example, financial organizations and transportation companies are subject to different tax base and apportionment provisions which, in some cases, result in dramatically varying tax burdens.

## Move to Reform—Replace SBT

SBT reform or replacement has been discussed for many years. In her campaign for governor in her first term (2003–2006), Governor Jennifer Granholm ran on a platform that included doing away with the SBT, which had gained the label of being a "job killer" due to the inclusion of compensation in the SBT base. In early 2005, the Governor offered a plan, the Michigan Jobs and Investment Act, to revise the SBT by eliminating tax relief for the service industry and other labor intensive businesses, lowering the tax rate, providing personal property tax relief to manufacturers, and increasing the tax on the insurance industry. The overall plan was revenue neutral. The proposal was not well received, with the principal complaint being that it unfairly picked winners and losers, and was particularly burdensome on the insurance industry in Michigan. A 15-percent personal property tax credit for manufacturers was ultimately passed in late 2005,<sup>26</sup> but the rest of the plan was not enacted.

In March of 2006, as the fall elections were approaching, the Republican-controlled legislature passed a bill to repeal the SBT that the Governor vetoed.<sup>27</sup> The stated reason for the repeal was that it was irresponsible to repeal the tax without a plan to replace the revenue. A petition drive was then initiated to place the question of repeal of the SBT on the November 2006 ballot. The petition called for accelerating the repeal of the SBT to the end of 2007. The petition drive was successful, and allowed the legislature to subsequently pass a "veto proof" initiated law to repeal the SBT as of December 31, 2007.<sup>28</sup> The passage of this initiated law precluded the need to seek a vote of the people to approve the repeal of the SBT. It provides that "(t)he Department of Treasury shall prorate the liability for the tax imposed in under the single business tax as necessary to impose the equivalent of a tax at the rate of zero on business activity after December 31, 2007."<sup>29</sup> The law also encourages the legislature "to adopt a tax that is less burdensome and less costly to employers, and more conducive to job creation and investment."<sup>30</sup>

Subsequent to the passage of this legislation the general elections were held, and Democratic Governor Granholm won re-election for a second term. Mirroring the result in the U.S. Congress, the Democrats also took over majority control of the House, while the Senate remained narrowly in control of the Republicans. The increased influence of the Democrats in the Michigan legislature

makes business tax cuts less likely in the 2007 session and increases the potential for a business tax increase. While there is a general consensus that the state of Michigan needs a tax structure more conducive to retaining and creating jobs, and also needs to consider reducing the burden of the personal property tax on businesses in the state, the state also faces serious fiscal challenges in 2006 including a significant projected budget deficit for 2007 and 2008. Michigan has a constitutional balanced budget amendment, and a projected budget deficit therefore mandates either spending cuts or revenue increases to avoid deficit spending. The replacement for the SBT needs to balance these budget issues with the objective of encouraging job creation and investment.

### **Alternative Replacement Plans**

A number of alternate replacement tax plans were developed in late 2006 after the legislation repealing the SBT was enacted. The following is a review of the principal plans developed in 2006 instructive of the issues faced in the SBT reform debate.

#### **Michigan Chamber Plan**

The Michigan Chamber of Commerce developed a proposal using four “guiding principles” and required that the tax be broad-based with a low rate, result in a net tax reduction, be simple to administer and easy to comply with, and be similar to other states’ tax structures. The result was a combination Business Income Tax and Business License Tax. The plan also includes a 50-percent personal property tax credit for all industries. Overall, the Chamber's plan would propose a \$500 million tax cut.

The Business Income Tax rate would be 3.05 percent. This tax would be paid on the excess above \$350,000 of gross receipts. It would include a \$150 minimum tax on businesses with at least one employee. Unitary filing would be mandatory for the Business Income Tax through the adoption of UDITPA. For unitary filers, the Joyce nexus standard applies, meaning that if one member has nexus in Michigan it does not create nexus for any other member of the unitary group in the state. The Business Income Tax is apportioned based on a 100-percent sales factor with no throwback rule. Special apportionment rules will be determined for certain industry groups such as financial in-

stitutions, transportation companies or insurance companies, similar to the SBT.

The general Business License Tax rate would be 0.48 percent and 0.24 percent on wholesale/retail companies. A \$2 million per return cap would apply. The License Tax would allow Michigan to assess all companies that do business in Michigan whether a company has its primary operations in Michigan or is an out-of-state company with a sales force in Michigan. The Business License Tax would be imposed at the affiliated group, consolidated and unitary levels. Special apportionment rules would also apply for industries such as insurance companies, transportation companies, banks, *etc.*

One controversial aspect of the Chamber's plan concerns the application and constitutionality of the \$2 million cap. Some argue that large companies can afford to pay more, while others argue that the largest taxpayers provide the greatest benefits to the economy and therefore deserve the greatest tax relief. Another interesting aspect of the Chamber's plan is the fact that a business organization is promoting the adoption of a unitary income tax, while normally governments promote unitary taxation and business interests oppose it. In addition, the administration has stated its opposition to granting utilities the personal property tax credit proposed in the plan.

#### **Detroit Chamber Plan**

The Detroit Chamber of Commerce issued a proposal in 2005 calling for an annual Michigan Business License Fee that would be based upon sales made by a business in Michigan to replace the SBT. These fees range from \$1,000 to \$1 million and would be determined based on the numerator of the SBT sales factor. The effective rate varies from about 0.2 percent to 0.5 percent. The maximum tax is set at \$1 million, which raises question regarding a tax “cap” similar to those presented by the Michigan Chamber of Commerce proposal. This proposal, like the Michigan Chamber of Commerce proposal, offers a \$500 million tax cut. This plan claims to simplify tax compliance and offer consistent revenue streams that grow with the economy.

#### **Grand Rapids Chamber Plan**

The Grand Rapids Chamber of Commerce developed a replacement tax proposal in 2006 that a “margin” tax on Michigan business activity. It is similar to the Texas Margin Tax in that one takes

the Michigan sales or service revenues less the cost of tangible personal property purchased for resale, manufacturing, leasing or cost of funds for financial institutions. The most fundamental difference between the Grand Rapids plan and the Texas tax is that the Grand Rapids Chamber did not propose an alternate deduction for compensation, as exists under the Texas Margin Tax. The Grand Rapids tax proposal is therefore less favorable to service businesses. The Michigan Business Activity Tax (MBAT) would replace the SBT and the personal property tax. The MBAT will not be considered an income tax; therefore, P.L. 86-272 would not apply. However, the Commerce Clause nexus standard would apply. The goal of the plan is to create a net business tax reduction, in turn, attracting and retaining more businesses. The rate is not to exceed 0.75 percent; however, there is some doubt concerning whether this is realistic. There is a flat fee of at least \$150 for businesses with at least one employee. A flat fee for filers with less than \$350,000 in gross revenue would apply. Consolidated filing may be elected; however, business activity would normally be determined on a single entity basis. This plan proposes a \$390 million tax cut.

### **Governor's Plan**

In December 2006, Governor Granholm proposed the Michigan Business Tax (MBT), which is also described as a "factor tax" that includes an asset tax, gross receipts tax, and income tax component. The goals of the MBT is to allow Michigan to become more competitive in the marketplace, enact a fair, simple and stable new tax; provide substantial personal property tax relief to industrial and commercial taxpayers; eliminate the tax on payroll, benefits and health care; preserve economic development tools; and spread the tax fairly amongst all types of business organizations. The plan would produce a net reduction of tax on Michigan businesses of \$150 million, which will be shifted to out of state companies. Governor Granholm does not want any cuts to be taken from the education system, health care or public safety funds. The tax would be levied upon the privilege of doing business and not on income or property. The rates imposed would be 0.125 percent for gross receipts, 0.125 percent for assets, and 1.875 percent for business income. Any taxpayer whose apportioned or allocated gross receipts are less than \$350,000 would not have to

file a return or pay the tax. The tax would be based on modified gross receipts and would be defined as "gross receipts" before apportionment or allocation. Under the legislation, if business income less dividends received is greater than zero, taxpayer's must multiply that amount by 15 and add it to gross receipts. Generally, taxpayers with business activity that is taxable both in and out of the state must utilize a single sales factor apportionment formula. A taxpayer with no sales in Michigan would apportion its tax base using the average of its property and payroll factors. Special apportionment provisions would be imposed for spun-off corporations, transportation companies and financial organizations.<sup>31</sup> The MBT estimates that 111,000 businesses will experience lower tax liabilities, while 34,000 will experience increased liabilities. It is important to note that no state imposes a tax on assets, and this portion of the tax raises the largest portion of revenue of the three components.

### **Fair Tax**

The Fair Tax would eliminate the state personal income tax, the SBT, the personal property tax, as well as the six million state education tax, and replace them all with a retail sales tax on new goods and services with an effective tax rate of up to nine percent. Used goods and business-to-business purchases used in the production of goods and services are not taxed. Some critics refer to the Fair Tax as a "regressive tax." The Fair Tax is by far the most ambitious proposal for expanding the sales and use tax. Because it proposes to increase the sales and use tax rate which is set by the Michigan Constitution, this proposal would require a state constitutional amendment. Numerous other suggestions for expanding the sales tax base to services have been raised that would leave the tax rate at its current level of six percent. Proposals for expanding the sales tax to services are expected to be part of the SBT replacement debate, but are also expected to continue to be considered regardless of what structure replaces the SBT given the shift of the U.S. economy from a goods-based economy to a services-based economy.

### **Issues with Replacement Plans**

#### **Issues with a Gross Receipts Tax**

There are many potential issues surrounding the enactment of a receipts-driven tax, as proposed by

the Michigan and Detroit Chambers, and by the Governor. Ohio recently enacted the Commercial Activity Tax (CAT) which is based on Ohio gross receipts. Although not fully phased in, a number of concerns have arisen with respect to the viability and constitutionality of the CAT. Following are some examples:

- **Economic nexus.** Ohio adopts an aggressive theory that every company with sales over \$500,000 is subject to tax, even without any in-state activity. The constitutionality of this rule under the Commerce Clause is uncertain.
- **Taxation of services.** The very concept of taxing services is unique, since most services are not subject to sales tax, and applying Ohio's rule of taxing services based on the location of the purchaser and not the service provider is very challenging.
- **Forced combined reporting.** Ohio adopted a very aggressive rule requiring affiliated taxpayers to file a combined returns and imposing joint and several liability on all affiliates in a combined group. They also established a "consolidated election" which is required to avoid the taxation of intercompany sales of goods and services. The complexity and burden of combined filing on large businesses with multiple separate business entities is significant.
- **Taxation of warehousing/distribution activity.** Companies that warehouse products in Ohio for shipment outside the state face a significant tax burden, and the rules for taxability and where delivery taxes place are complex. Law changes are being studied but they raise Commerce Clause constitutional issues.
- **Trading activities.** Any business that engages in any sort of trading, such as utilities (gas, oil, electricity) or commodities (grain, produce), face significant issues in terms of the measure and burden of the tax and how to determine what receipts are taxable in Ohio.
- **Financial transactions.** Even more complex than trading physical goods, financial trading (futures, options, hedging, foreign currency), and other financial transactions (repurchase agreements, factoring, reinsurance, *etc.*) face huge challenges in terms of measurement and sourcing.
- **Expense reimbursements/agency issues.** Major issues exist in determining when income received on behalf of another or reimburse-

ments for expenses constitute taxable receipts. The taxation of these items results in multiple taxation or "pyramiding" similar to the issues in the taxation of distribution, trading or financial transactions.

- **Quarterly reporting burdens.** Determining taxable receipts on a quarterly basis is especially challenging for companies other than retailers that do not collect and remit sales tax, and are only set up currently to do annual reporting with quarterly estimates.
- **Taxability of food.** While food sales are currently taxed under the CAT, there is uncertainty regarding the legality of taxing food under the state constitution and political efforts to exempt food transactions.
- **Exemptions.** The CAT has numerous exemptions whose scope and limitations have yet to be addressed, since the CAT is a novel tax without limited precedent from other states.
- **Transition and credits.** The five-year phase-out of the franchise tax and complex rules for credits that carry over from the franchise tax add to the complexity of the CAT implementation.
- **Cross-industry equity issues.** Serious dissent continues to exist in Ohio regarding the wisdom of enacting the CAT and the shifting of tax burdens between industries that it has created. Calls for its repeal began as soon as it was enacted and continue today.

### Issues with a Margin Tax

Similar to a gross receipts based tax, a tax structure similar to the one recently implemented in Texas (referred to as the "Margin Tax") and proposed by the Grand Rapids Chamber is also very controversial. The following lists some of the potential issues identified related to the Texas Margin Tax:

- Difficult to account for deferred taxes and accrued liabilities for such a unique tax due to the significantly different base
- Difficult to evaluate cost of goods sold (COGS) components and focus on the availability of specified COGS items due to differing qualifiers related to "production or acquisition" or "directly used in production." Additionally, how should one go about capturing the financial data necessary to compute and document the cost of goods sold deduction?

- Difficult to determine flow through entities' tax bases and apportionment formulas, as well as exclusion of flow-through entity revenue, cost of goods sold, compensation and receipts factors from "parent" computations
- Difficult to determine combined group and whether combination is before or after the tax computation (*i.e.*, if rates differ by industry, can these be applied by company or after combination?)
- Uncertainty and increased complexity in applying the economic nexus standard and in choosing apportionment and sourcing methodologies for certain services
- Ambiguity surrounding whether NOLs are permitted to be used against the margin tax, and, if not, whether (and how) accumulated NOLs can be used under temporary credit
- As enacted, the law lacks clear definitions for all major components of the tax including exemptions/exclusions.
- State agencies face several challenges including developing computer systems to capture combined reports, training audit and tax policy personnel in unique and complex tax structures, timely drafting regulations and interacting with industry and accounting firms to assist with complex issues.

### Issues with Expanding the Sales Tax to Services

Much criticism has stemmed from the suggestion of applying a sales tax on services as outlined in the Fair Tax proposal. The largest problem noted is the inherent inequity of "pyramiding" through the taxation of business-to-business transactions. It is noted that the taxation of business-to-business services would tend to punish small business, since those companies are most likely to need to outsource services to other businesses and least likely to operate in a vertically integrated fashion. This detriment to small business is a major hurdle in the taxation of services. The taxation of health care is another controversial issue. Excluding business-to-business and health care services would eliminate roughly two-thirds of the services that could be taxed. The inevitable debate over inclusion or exclusion of other services, and the definitional challenges are other challenges in the consideration of an expansion in the sales tax base.

### Issues with an Apportioned Asset Tax

There are serious questions regarding the constitutionality of a tax imposed on assets and apportioned based on sales in the state. A review of a similar constitutional challenge to the SBT considered by the U.S. Supreme Court in *Trinova* suggest that a challenge be successful.

In *Trinova*, the Court rejected a challenge to apportionment of the compensation portion of the SBT base by concluding that the SBT is not a tax on compensation, but an indivisible tax upon a *bona fide* measure of business activity—the value added—not three separate and independent taxes on compensation, depreciation and income. Unlike the SBT, the new Michigan Business Tax mixes three unrelated measures: assets, net income multiplied by 15 and gross receipts, and there is no suggestion that this aggregate number measures anything in particular. The Governor's administration's own descriptions of the plan describe it as three taxes with three separate rates, and while they may refer to the tax as having a single base, the lack of any relevance to that base in the aggregate, coupled with their own descriptions, strongly suggests that it would be viewed as three separate taxes by a court. Therefore, a constitutional challenge to a sales apportioned asset tax may succeed because under *Trinova*, each component of the tax must be tested for constitutionality separately.

It could be argued that a tax on net assets is comparable to a net worth tax, and net worth taxes are recognized as being able to be apportioned. However, while there may be some similarities between net worth and net assets, the accounting concept of measuring net worth is very different, because the latter considers liabilities and reserves. Thus, one can easily understand why "net worth" is not subject to precise geographic measurement, while assets are. The concern is that the tax on assets is simply a property tax on tangible and intangible property, and taxing property outside of Michigan based on sales in Michigan is discriminatory.

There may be other potential technical problem with the tax. Section 91 of the MBT proposal provides that if the tax is considered subject to P.L. 86-272, the income and asset portions of the tax are severed, and it converts to a 0.375-percent tax on gross receipts. This is the same result which occurs under that provision if the apportionment of the asset or income measures

of the tax are held unconstitutional. The MBT is very likely to be considered a tax subject to P.L. 86-272. If viewed as three separate taxes, it is clear that the income tax is subject to P.L. 86-272 as a tax “on or measured by income.” While the plan apparently seeks to avoid this result by combining the three taxes together into a single base, for the same reasons noted above, it is difficult to see this being sustained.

There are several other issues acknowledged by the administration related to the MBT proposal including the policy wisdom of adopting a throwback rule, the use of the existing SBT combination rules versus the adoption of a unitary filing method, the use of a tax versus a book measure of assets, questions regarding the sourcing of interest income, the treatment of inter-company sales, the definition of “assets” for purposes of computing the base, the treatment of flow-through entities and holding companies and many more.

## Commentary and Conclusion

Throughout its lifespan, the SBT has been described in many ways. At its onset, it was considered a viable revenue-producing source; at its demise, overly burdensome and complex. It served its purpose for many years, but at this critical juncture, with a struggling Michigan economy, it is of enormous importance to reach an agreement concerning the adoption of an effective replacement plan. The decision will require a careful weighing of business, government and citizen interests, and will hopefully work towards balancing budget issues and creating new jobs. As taxpayers, policy makers, and administrators take a hard look at the different options presented, and as these options are further clarified, the next chapter in Michigan's business tax saga will be written.

### ENDNOTES

- <sup>1</sup> MCL 208.31, MCL 208.6(1).
- <sup>2</sup> *Gillette Co. v. Dep't of Treasury*, 198 Mich. App. 303, 497 NW2d 595 (1993), *app. den.*, 445 Mich. 861, 519 NW2d 156 (1994).
- <sup>3</sup> *Jones and Laughlin Steel Corp v. Michigan Dep't of Treasury*, 145 Mich. App. 405 (1985).
- <sup>4</sup> 1987 Mich Pub Acts 39.
- <sup>5</sup> *Trinova Corp. v. Michigan Dep't of Treasury*, 433 Mich. 141, 445 NW2d 428 (1989).
- <sup>6</sup> *Trinova Corp. v. Michigan Dept. of Treasury*, (89-1106), 498 US 358 (1991).
- <sup>7</sup> *Id.*, at 377.
- <sup>8</sup> *Caterpillar, Inc. v. Michigan Dep't of Treasury*, NOS-84-9664-CM, 87-11109-CM (1989).
- <sup>9</sup> *Caterpillar, Inc. v. Michigan Dep't of Treasury*, 188 Mich. App. 621, 470 NW2d 80 (1991).
- <sup>10</sup> MCL 208.27a(6).
- <sup>11</sup> Michigan House Fiscal Agency Fiscal Forum, Vol 3, No 2 (Oct. 1, 1997), at 3.
- <sup>12</sup> *Caterpillar, Inc. v. Dep't of Treasury*, 440 Mich. 400, 488 NW2d 182 (1992).
- <sup>13</sup> *Thiokol Corp. v. Roberts*, 858 FSupp 674 (1994).
- <sup>14</sup> 26 USC §7421(a).
- <sup>15</sup> *Thiokol Corp., v. Roberts*, 76 F3d 751 (Mich. 1996), *Thiokol Corp. v. Michigan Dep't of Treasury*, 117 SCT 2448 (1997).
- <sup>16</sup> *Jefferson Smurfit Corp v. Michigan Dep't of Treasury*, No. 120925 (Docket) (Mich. Dec. 28, 1999).
- <sup>17</sup> *Jefferson Smurfit Corp. v. Michigan Dep't of Treasury*, 248 Mich. App. 271, 639 NW2d 269 (2001).
- <sup>18</sup> *Dana Corp v. Michigan Dep't of Treasury*, No. 129573 (Docket) (Mich. Jun. 9, 2004).
- <sup>19</sup> *Dana Corp v. Michigan Dep't of Treasury*, 267 Mich. App. 690, 706 NW2d 204 (2005).
- <sup>20</sup> *Dana Corp v. Michigan Dep't of Treasury*, 474 Mich. 1111, 711 NW2d 748 (2006).
- <sup>21</sup> *Gillette, supra* note 2; *Guardian Industries Corp. v. Dep't of Treasury*, 198 Mich. App. 363, 499 NW2d 349, *lv app den* 444 Mich. 943; 512 NW2d 846 (1994).
- <sup>22</sup> Revenue Administrative Bulletin 1998-1 (Feb. 24, 1998).
- <sup>23</sup> *Little Caesar Enterprises v. Michigan Dep't of Treasury*, 575 NW2d 562, 226 Mich. App. 624, *appeal denied*, 595 NW2d 854, 459 Mich. 1000 (1997); *Mobil Oil Corp. v. Michigan Dep't of Treasury*, 373 NW2d 730, 422 Mich. 473 (1985); *Realtron Corp. v. Michigan Dep't of Treasury*, MTT No. 173926, 2001 WL 1818094; *Zenith Data Systems v. Michigan Dep't of Treasury*, 555 NW2d 264, 218 Mich. App. 742 (1996).
- <sup>24</sup> *Perry Drug Stores, Inc. v. Michigan Dep't of Treasury*, 582 NW2d 533, 229 Mich. App. 452 (1998); *J.C. Penney Co., Inc. v. Michigan Dep't of Treasury*, 429 NW2d 631, 171 Mich. App. 30 (1988); *Town & Country Dodge, Inc. v. Michigan Dep't of Treasury*, 362 NW2d 618, 420 Mich. 226 (1984).
- <sup>25</sup> *Guardian Photo, Inc. v. Michigan Dep't of Treasury*, 621 NW2d 233, 243 Mich. App. 270 (2000).
- <sup>26</sup> Public Acts 290–93 of 2005.
- <sup>27</sup> 2006 House Bill 5743.
- <sup>28</sup> Public Act 325 of 2006.
- <sup>29</sup> Public Act 325 of 2006, Section 2.
- <sup>30</sup> Public Act 325 of 2006, Section 1.
- <sup>31</sup> 2006 House Bill 6676.

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