

The Belle of the Ball — A Unitary Case of First Impression

by Lynn A. Gandhi



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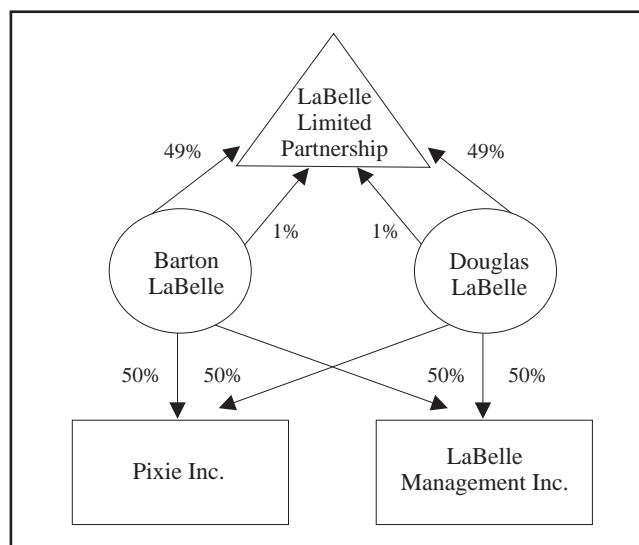
In this edition of *Smitten With the Mitten*, Gandhi reviews *LaBelle Management Inc.* and the definition of indirect ownership in regards to a unitary business group. At issue was whether there was sufficient indirect ownership or control to satisfy the statutory definition. Gandhi notes that the matter could be clarified by legislative amendment to the statute but says that whether that path will be taken remains to be seen.

On March 31, the Michigan Court of Appeals issued a published decision in a case of first impression regarding the determination of a unitary business group in *LaBelle Management Inc.*¹ At issue was the definition of indirect ownership contained in the statute defining the control test of a unitary business group.² The Michigan Department of Treasury had determined that the taxpayer was a member of a unitary business group. The taxpayer disagreed with Treasury's determination and contested the determination at the Court of Claims.³ The Court of Claims agreed with Treasury, and the taxpayer appealed.

The Facts

The case involved three entities during the years at issue: LaBelle Management Inc. (LaBelle), Pixie Inc. (Pixie), and LaBelle Limited Partnership (Limited). LaBelle, a Michigan corporation, was primarily owned by two brothers, Barton and Douglas LaBelle, neither of whom owned more than 50

percent of the company's common stock.⁴ Pixie, also a Michigan corporation, had originally owned LaBelle, but on January 1, 2008, it sold its interest in LaBelle to the brothers. Neither brother owned more than 50 percent of Pixie's common stock.⁵ Limited was a Michigan limited liability partnership. To form Limited, each brother held both a 1 percent general partnership interest and a 49 percent limited partnership interest. The partnership was later amended to add the brothers' children as limited partners, reducing the brothers' share of the limited partnership.⁶



After being sold by Pixie, LaBelle filed its Michigan business tax (MBT) return as a separate company. Treasury conducted an audit for 2011 and 2012 and determined that LaBelle, Pixie, and Limited composed a single unitary business group based on MCL 208.1117(6), which defined a unitary business group as:

a group of United States persons, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest

¹No. 324062, slip op. (Mich. Ct. App. Mar. 31, 2016). An order was issued by the Michigan Court of Appeals on April 5 to amend the opinion to correct a clerical error (the omission of the word “dispositive” in the first sentence of the last paragraph on p. 3. In all other respects, the March 31 opinion remains unchanged).

²MCL 208.1117(6). The case dealt with tax years 2011 and 2012, governed by both the Michigan business tax and the Michigan corporate income tax. However, the definition of unitary business group has not changed. The definition under the Michigan corporate income tax is at MCL 206.611(6).

³No. 13-000095-MT.

⁴Slip op. at 1.

⁵Slip op. at 2.

⁶Slip op. at 2.

with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.

Treasury contended that LaBelle indirectly owned 100 percent of Pixie and Limited and that Pixie indirectly owned 100 percent of LaBelle and 90 percent of Limited.⁷ In making its determination, Treasury relied on Revenue Administrative Bulletin (RAB) 2010-1, “Unitary Business Group Control Test,” which provided that in interpreting the term “indirect ownership,” Treasury would rely on IRC section 318 to include ownership through attribution as well as constructive ownership.⁸ In the RAB, Treasury stated that “ownership interests constructively owned by a person . . . shall . . . be considered as actually owned by such person.”⁹ LaBelle disputed that the phrase “indirect ownership” incorporated Treasury’s interpretation of constructive ownership and that the three entities constituted a unitary business group. LaBelle challenged Treasury’s interpretation of the term “indirect ownership” and protested the assessments to the Court of Claims.

Definition of ‘Indirect’ Ownership

The key issue at both the Court of Claims and court of appeals was whether there was sufficient indirect ownership to meet the requirement contained in the statute, “which requires one member of a unitary business group to directly or *indirectly* own or control more than 50 percent of the ownership interests of the other members.”¹⁰ The parties all agreed that no one entity directly owned more than 50 percent of any single entity. The courts had to determine if there was sufficient *indirect* ownership to satisfy the statutory control test. The Court of Claims based its finding on the fact that there was sufficient indirect ownership accord-

ing to provisions contained in the Internal Revenue Code.¹¹ Finding the same “more than 50 percent” language in the federal code, the Court of Claims relied on the guidance of RAB 2010-1 to determine that “26 U.S.C. 957 ‘applies the same attribution rules under IRC section 318 as are applied by the Department to determine ownership interest under section 1117 of the MBT.’”¹² Accordingly, the Court of Claims upheld Treasury’s determination, which the court found was “also consistent with the legislative purpose of reducing avoidance.”¹³

On appeal, the court of appeals found that the Court of Claims had erred in using the federal tax definition of *constructive ownership* to define the term “indirect ownership.” Succinctly, the court of appeals continued the strict constructionist posture strongly adopted and applied by the Michigan Supreme Court. In summarizing the dispositive issue as “how to define ‘owns or controls . . . indirectly,’” the court of appeals acknowledged that the Michigan Business Tax Act¹⁴ does not define indirect ownership or control.¹⁵ The court further noted that the act provided that “a term used in this act and not defined differently shall have the same meaning as when used in comparable context in the laws of the United States related to federal income taxes in effect for the tax year unless a different meaning is clearly required.”¹⁶ Citing case precedence, the court of appeals stated, “When employing federal tax laws to define a statutorily undefined term, the federal context must be comparable to the Michigan context.”¹⁷ When the federal tax laws lack a comparable context, the court confirmed, “the Legislature intended that the word was to be construed according to its ordinary and primary understood meaning.”¹⁸ Under established Michigan law, a dictionary definition is acceptable.¹⁹

Lack of a Comparable Context

The court of appeals also found that the Court of Claims erred when it failed to follow the standard rules of statutory construction. The court of appeals noted that once the Court of Claims had determined that “no [federal income tax] provision is directly comparable” to the concept of a

⁷Slip op. at 2.

⁸RAB 2010-1 at 7. RAB 2010-1 was issued February 5, 2010. Revenue administrative bulletins are written pronouncements of the department’s interpretation of tax laws. They are not promulgated under the state’s Administrative Procedures Act, MCL 24.201, and therefore do not have the force of law. The extent to which the Michigan courts follow the guidance contained in RABs is best summarized by *In re Complaint of Rovas*, 482 Mich. 90; 754 N.W.2d 259 (2008), which indicated that RABs are given “respectful consideration which is not the equivalent of ‘deference.’” 482 Mich. at 108.

⁹RAB 2010-1 at 9.

¹⁰Slip op. at 2.

¹¹Specifically, by reference to 26 U.S.C. 957, the provisions regarding combined returns in the context of a controlled foreign corporation, and when the income of a CFC must be included in the return of a U.S. shareholder. These provisions contain the “more than 50 percent” language used in the Michigan statute.

¹²Slip op. at 2.

¹³Slip op. at 2.

¹⁴MCL 208.1101 et. seq.

¹⁵Slip op. at 4.

¹⁶Slip op. at 4, citing MCL 208.1103.

¹⁷Slip op. at 4, citing *Town & Country Dodge Inc. v. Dep’t of Treasury*, 420 Mich. 226, 240; 362 N.W.2d 618 (1984).

¹⁸Slip op. at 4, *Id.*

¹⁹Slip op. at 4, citing *Consumers Power Co. v. Dep’t of Treasury*, 235 Mich. App. 380, 385; 597 N.W.2d 274 (1999).

unitary business group contained in MCL 208.1117, the court should have looked to the ordinary meaning of the term “indirectly.” Instead, the Court of Claims adopted a “contextually analogous” provision contained in the IRC regarding international taxation of “controlled foreign corporations.”²⁰ In reviewing the provisions relied on by the Court of Claims, the court of appeals found that “federal statutes and regulations are careful never to say that indirect ownership *means* constructive ownership and, in fact, at times expressly distinguish between the two.”²¹ As noted by the court of appeals, “mere similarity between the language used in the RAB and the language of the federal code” is not a reason to ignore the lack of a comparable context.²²

The court of appeals also noted that none of the terms at issue (for example, “directly,” “indirectly,” and “constructively”) are actually defined by the federal code, although the federal code has myriad examples illustrating “the proposition that indirect ownership and constructive ownership are two different concepts.”²³ Lacking a comparable federal context, the court of appeals turned to the plain and ordinary meaning of the term “indirectly” contained in oft-cited dictionaries.²⁴ Consistent with these definitions, the court of appeals held that “indirect ownership in MCL 208.1117(6) means ownership *through an intermediary*, not ownership by operation of legal fiction.”²⁵ The court of appeals noted that federal law applies constructive rules of ownership only when the statute specifically directs to do so, which MCL 208.1117 does not. To read the term “con-

structive” into MCL 208.1117 would expand the statute beyond the meaning intended by the Legislature.²⁶

Applying this dictionary definition to the parties, the court of appeals found that no unitary business group existed, “as none of the entities owed, through an intermediary or otherwise, more than 50 percent of any other entity.”²⁷ Treasury filed a motion for reconsideration, which the court of appeals denied.²⁸ Treasury also filed a motion to stay the effect of the March 31, opinion, along with a motion for immediate consideration.

Notice Issued by Treasury

On May 4, 2016, Treasury issued a notice to taxpayers regarding *LaBelle Management Inc.* that acknowledges the court of appeals’ decision. The notice indicated that consistent with a series of Michigan cases, the published decision requires Treasury to give full retroactive effect to the decision, thus applying *LaBelle* to all open tax years.²⁹ This is despite the contrary guidance issued by Treasury in RAB 2010-1. The notice also urged taxpayers to review their unitary group membership to determine if the requisite level of control existed after *LaBelle*.³⁰ If the requisite control of greater than 50 percent was not met, amended returns may be required, depending on the statute of limitations.³¹ Alternatively, separate returns may also be required. Treasury noted that further evaluation would be completed and that compliance instructions would be forthcoming upon Treasury’s completion of its review.

The speed at which the notice was issued exhibits a departure from Treasury’s past practices and was applauded by the practitioner community as evidence of Treasury’s goal to avoid unnecessary litigation and provide timely guidance to taxpayers. Such goodwill was quickly dashed.

Update to Notice

The notice was updated on May 11 to reflect that on May 5 the court of appeals granted Treasury’s motion to stay the effect of the published opinion until Treasury has exhausted all of its appellate rights.³² On May 16, Treasury’s motion for reconsideration was denied. Treasury has until June 27 to file an application for leave to the Michigan Supreme

²⁰Slip op. at 4. The Michigan Court of Appeals expressly noted that the Court of Claims had acknowledged the lack of a comparable federal context. For those practitioners who have speculated that the court of appeals would likely rubber-stamp any decision of the Court of Claims (because of the chief judge of the Court of Claims is also the chief judge of the court of appeals), this decision stands in stark contrast to such allegations.

²¹Slip op. at 6.

²²Slip op. at 6. In reviewing the federal code provision relied upon by the Court of Claims, the court of appeals found that the federal statute identifies three distinct kinds of ownership, which were direct, indirect, and constructive ownership. The court of appeals noted that constructive ownership is not true ownership but rather “considered as owned” — that is, a legal fiction.

²³Slip op. at 5. The court of appeals cited to the lengthy regulations that exist regarding constructive ownership rule, which are used to determine indirect ownership under section 318 (cited in RAB 2010-1), such as 26 CFR 1.382-2T(f)(15) (2015) and 1.704-1(b)(2)(iii)(d)(6) (2015). The court also noted the regulations used for purposes of indirect ownership under section 544, which are 26 CFR 1.856-1(d)(5) (2015) and 1.861-8T(c)(2)(ii) (2015). Given the natural disposition of the court of appeals to be less than enthused to hear tax cases, the justices must have greeted their review of these regulations with less than rabid enthusiasm. They should be commended for their tenacity.

²⁴The court of appeals cited to the definitions contained in the *New Oxford American Dictionary* (3rd ed.), *Merriam-Webster’s Collegiate Dictionary* (11th ed.), and *Black’s Law Dictionary* (10th ed.).

²⁵Slip op. at 7 (emphasis in the original).

²⁶Slip op. at 8. See *Detroit Edison Co. v. Dep’t of Treasury*, 498 Mich. 28, 46; 869 N.W.2d 810 (2015) (agencies cannot exercise legislative power by creating law or changing the laws enacted by the Legislature).

²⁷Slip op. at 8.

²⁸The motion for reconsideration was filed April 21.

²⁹Notice at p. 1, available at www.michigan.gov/treasury/ under the caption Latest News. The cases cited by Treasury in the notice include *Syntex Laboratories v. Dep’t of Treasury*, 233 Mich. Ct. App. 286 (1998); *Rayovac Corp. v. Dep’t of Treasury*, 264 Mich. Ct. App. 441 (2004); *JW Hobbs v. Dep’t of Treasury*, 268 Mich. Ct. App. 38 (2005); *Int’l Home Foods Inc. v. Dep’t of Treasury*, 447 Mich. 983 (2007).

³⁰Notice at 2.

³¹Notice at 2.

³²See Order of the Court of Appeals (May 5, 2016).

Court.³³ Until then, Michigan taxpayers are left in limbo regarding the application of the *LaBelle* decision. Given the limited application of the decision for MBT years, for which most years are closed by statute, as well as the potential for limited application to the corporate income tax due to the availability of the affiliate group election,³⁴ it will be interesting to see whether Treasury files an application for leave, and if so, whether the supreme court will deem the decision worthy of review. Obviously, Treasury could remedy the situation by pursuing a legislative amendment to the statute. Whether this path will be taken remains to be seen, especially given the lame-duck session following the November elections. The Legislature's session will end in late December. ■

³³MCR 7.305(C).

³⁴The affiliate election is contained at MCL 206.691(2), which provides:

A person that is part of an affiliated group may elect without the consent of the department to have all of the persons that are included in that affiliated group to be treated as a unitary business group. A taxpayer that elects to file as a unitary business group pursuant to this subsection shall compute its tax under this part in accordance with all other provisions of this part that apply to a unitary business group. The taxpayer shall make the election under this subsection on a form or in a format as prescribed by the department that is to be filed in a timely manner with the taxpayer's annual return. Each person included in the affiliated group is deemed to have agreed to be bound by the election made under this subsection and any renewal of that election and to have waived any objection to its inclusion in the affiliated group and treatment as a unitary business group. Each person that subsequently enters the affiliated group after the tax year for which the election is made is deemed to have consented to the application of and is bound by the election and to have waived any objection to its inclusion in the affiliated group and treatment as a unitary business group. An election made pursuant to this subsection is irrevocable and binding for and applicable to the tax year for which it is made and for the next 9 tax years. The election shall remain in effect for the time period in which the ownership requirements under this section are met irrespective of whether a federal consolidated group to which the unitary business group belongs discontinues the filing of a federal consolidated return or whether the common parent changes due to a reverse acquisition or acquisition by a related person. Upon the expiration of the election after it has been in effect for 10 tax years, an election may be renewed for another 10 tax years, without the consent of the department; provided however, that in the case of a nonrenewal a new election under this subsection is not permitted in any of the immediately following 3 tax years. The renewal shall be made on a form or in a format as prescribed by the department that is to be filed in a timely manner with the taxpayer's annual return after the completion of a 10-year period for which an election under this subsection was in place.

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