

**THE MICHIGAN BUSINESS TAX TAXPAYER: JURISDICTION
TO TAX AND THE UNITARY BUSINESS GROUP**

JUNE SUMMERS HAAS[†]

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I. INTRODUCTION

Among the many changes in taxation brought about by the new Michigan Business Tax Act (MBT),¹ one of the biggest changes is to the taxpayer under the new tax. The MBT asserts a broadly expanded economic presence nexus standard that will increase the number of businesses subject to the tax in Michigan. The MBT also imposes the use of a unitary business group as the taxpayer. Both the use of economic presence nexus and mandatory unitary filing will have profound changes on where the burden of this new tax falls. This article examines both the nexus standards and new unitary business group concept under the MBT.

[†] Partner, Honigman Miller Schwartz and Cohn LLP, Lansing, Michigan. B.S., 1983, with distinction, George Mason University; J.D., 1986, University of Virginia. Past Michigan Commissioner of Revenue for three years, nationally-recognized expert on nexus issues, in the forefront of litigation on retroactive application of nexus standards, establishing Michigan’s casual transaction exclusion, and distinguishing between sales of services and sales of tangible property, past consultant to the Michigan Chamber of Commerce and the Legislature in drafting the new Michigan Business Tax.

1. MICH. COMP. LAWS ANN. § 208.1101 *et seq.* (West 2008).

II. WHO IS SUBJECT TO THE TAX?

Any person with nexus conducting business activity in Michigan is subject to the MBT.² The term “person” is all inclusive under the new Michigan Business Tax as in the repealed Michigan Single Business Tax (SBT).³ Person is defined to include any person, partnership, limited liability company, receiver, estate, trust, individual or any other group or combination of groups that act as a unit.⁴ Many states do not tax partnerships or individuals under their business activity tax. This is in stark contrast to the MBT, and the effect is that some persons and entities will be paying taxes in Michigan when they do not pay business activity taxes elsewhere.

III. CONSTITUTIONAL RESTRICTIONS ON JURISDICTION TO TAX

Michigan’s jurisdiction to impose the MBT is limited by the U.S. Constitution, applicable federal statutes, and specific statutory nexus standards. The Due Process and Commerce Clauses of the U.S. Constitution define U.S. constitutional limitations on state jurisdiction to tax. The nexus requirements of both Clauses must be satisfied before an out-of-state business may be subject to the taxing jurisdiction of a State. Due Process nexus is satisfied for application of the MBT when a person has economic or physical presence in Michigan.⁵ Economic presence is satisfied when a business, on its own or through a representative, purposefully avails itself of the benefits of an economic market in Michigan.⁶ For example, the U.S. Supreme Court has held that engaging in continuous and widespread solicitation of business within a state constitutes economic presence.⁷

The U.S. Supreme Court has provided little guidance on Commerce Clause nexus requirements for business activity taxes. Most recently the Court has addressed the Commerce Clause substantial nexus requirement for use tax collection in *Quill*.⁸ In *Quill*, the Supreme Court stated that substantial nexus for use tax collection is a bright line physical presence test.⁹ The Court reaffirmed its twenty-five year old holding in *National Bellas Hess Inc. v Dept. of Rev. of the State of Illinois*,¹⁰ that those persons whose contacts with a State do not exceed U.S. mail or common

2. MICH. COMP. LAWS ANN. § 208.1200 (West 2008).

3. 1975 Mich. Pub. Acts 228 (repealed 2007).

4. MICH. COMP. LAWS ANN. § 208.1113(3) (West 2008).

5. See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); see also *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985); see also *Int’l Shoe v. Washington*, 326 U.S. 310 (1945).

6. *Quill*, 504 U.S. at 306-08.

7. *Id.* at 308.

8. *Id.*

9. *Id.* at 317.

10. 386 U.S. 753 (1967).

carrier do not have substantial nexus and cannot be required to collect use taxes.¹¹ The Court noted that substantial nexus for use tax collection is satisfied by the presence of a small sales force, plant, or office in the taxing state.¹² In a footnote, the *Quill* Court commented that it had previously rejected a “slightest presence standard of constitutional” nexus.¹³

The *Quill* Court acknowledged that the physical presence rule has not been applied to other taxes stating, “although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.”¹⁴ The Court noted that “contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today.”¹⁵ This leaves open the question of whether a physical presence standard or an economic nexus standard applies to business activity taxes. Supreme Court cases have not addressed the constitutionality of imposing a business activity tax on an entity whose sole connection to the state is making sales or loans to an entity domiciled within the state or making loans secured by assets located within the state.¹⁶ Nonetheless, there is no question that when an entity has physical presence in a State, substantial nexus under the Commerce Clause exists for imposition of the state’s business activity tax.

Currently there is a vigorous debate over the appropriate constitutional standard under the Commerce Clause for imposition of business activity taxes. The U.S. Supreme Court has clearly established the requirement of a “substantial nexus” between the state and the business the state is trying to tax in order for states to constitutionally impose a business activity tax.¹⁷ However, what the term “substantial nexus” means is the center of the debate. There are two competing

11. *Id.* at 758-59.

12. *Id.* at 757.

13. *Quill*, 504 U.S. at 315 n.8 (quoting *Nat’l Geographic Soc’y v. Cal. Bd. of Equalization*, 430 U.S. 551, 556) (1977) (quotations omitted)).

14. *Quill*, 504 U.S. at 314.

15. *Id.* at 311.

16. On June 18, 2007, the US Supreme Court denied certiorari in two state tax cases applying an economic presence nexus standard. The first case held that a business activity tax could be imposed on a bank that solicited sales of credit cards and maintained debtor-creditor relationships with customers in the state. *MBNA Am. Bank, N.A. v. Tax Comm’r of State*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007). The second case held that New Jersey’s corporate business tax would be imposed upon a company that did no more than license trademarks for use in the state. *Lanco, Inc. v. Division of Tax’n*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007). Denial of certiorari is not a judgment on the correctness of the lower court opinion.

17. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (providing that the Commerce Clause requires a tax (1) to be applied to an activity with substantial nexus with the taxing state, (2) to be fairly apportioned, (3) to not discriminate against interstate commerce, and (4) to be fairly related to the services provided by the state).

theories – physical presence versus economic presence – being debated in courtrooms across the country.¹⁸ It is beyond the scope of this article to provide more than a brief overview of the opposing arguments.

A. *Physical Presence*

Physical presence advocates assert that corporation must have a physical presence in a state in order to be subject to a state's jurisdiction to tax in order to fulfill the Commerce Clause goal of creating a free flowing national economy unencumbered by discriminatory, arbitrary jurisdictional standards of the states.¹⁹ *Quill* supports this position.²⁰ In *Quill*, the U.S. Supreme Court established a physical presence requirement for use tax collection by the states. In evaluating the Commerce Clause standard, the Court noted that *Bellas Hess*, which established that the physical presence standard “is not inconsistent with *Complete Auto* and our recent cases” even though “contemporary Commerce Clause jurisprudence might not dictate the same result today.”²¹ The Court also stated, “although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.”²² In other words, the Court stated that it may apply a physical presence standard like that of *Bellas Hess* to other taxes under *Complete Auto*. Finally, the Court noted that physical presence requirement “furthers the ends of the dormant Commerce Clause.”²³ Thus, advocates of the physical presence standard for business activity tax nexus argue for the enforcement of this clear standard and point to U.S. Supreme Court case law as upholding this standard as a logical extension of its current nexus jurisprudence.²⁴

18. There are at least two current efforts to address the competing theories in the legislative political arena rather than waiting for judicial decisions. See H.R. 2526, 107th Cong. (2001); MULTISTATE TAX COMM'N., FACTOR PRESENCE NEXUS STANDARD FOR BUSINESS ACTIVITY TAXES (2002), available at <http://www.mtc.gov> (accessed from homepage by entering “Factor Presence Nexus Standard for Business Activity Taxes” into the Search box and selecting “Uniformity Projects A to Z”) (last visited June 10, 2008).

19. See *Quill*, 504 U.S. at 311.

20. *Id.*

21. *Id.*

22. *Id.* at 314.

23. *Id.*

24. See, e.g., Scott D. Smith & Sharlene Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, 25 STATE TAX NOTES 787 (2002); see also Scott D. Smith, *MTC's Factor Presence Nexus Standards are Unconstitutional*, 25 STATE TAX NOTES 1043 (2002).

B. Economic Presence

Economic presence advocates assert that corporations can do business within states without any physical presence and the only logical standard is to provide that economic presence of the corporation evidenced by purposeful availment of the economic market in the state is sufficient to establish nexus. State advocates of the economic presence theory point to what they deem as a “reluctant affirmance” of the *Bellas Hess* physical presence requirement.²⁵ They also argue that the Court’s statement that “contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today”²⁶ means that were the issue arise for the first time in a case involving business activity tax nexus, the Court would not impose a physical presence standard under the Commerce Clause today. Moreover, the state advocates point to two cases as upholding application of an economic presence standard to business activity taxes. In *Int’l Harvester v. Wisconsin Dep’t. of Taxation*, the Supreme Court upheld the constitutionality of a Wisconsin tax on the privilege of declaring and receiving dividends.²⁷ The tax was collected from the corporation clearly present in the state on dividends paid to nonresident shareholders.²⁸ Economic presence advocates point out that the Court stated, “it has never been thought that residence within a state or county is a sine qua non of the power to tax.”²⁹ From this, the advocates conclude that to impose a corporate tax does not require physical presence.³⁰ Advocates also cite the *JC Penny* case in which the court sustained the same tax stating insert the requisite nexus is supplied if the corporation avails itself of the “substantial privilege of carrying on business within the State.”³¹

Without any Supreme Court guidance, state courts have been deciding whether to impose an economic presence theory. Recent state court cases have upheld an economic presence theory for imposition of state business activity taxes on intangible holding companies that license use of intangibles in the state³² and on financial institutions that solicit

25. See, e.g., John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 31 STATE TAX NOTES 341, 345 (2004).

26. *Quill*, 504 U.S. at 311.

27. 322 U.S. 435 (1944).

28. *Id.* at 437.

29. *Id.* at 443.

30. See Dan Bucks & Frank Katz, *Explanation of the Multistate Tax Commission’s Proposed Factor Presence Nexus Standards*, 25 STATE TAX NOTES 1037 (2002) (providing a complete explanation of the case for economic presence); see also John A. Swain, *State Income Tax Nexus: Making the Case for an Economic Presence Standard in Light of Quill*, 9 MULTISTATE TAX REP. 965 (2002).

31. *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444-45 (1940).

32. See, e.g., *Lanco, Inc. v. Dir. Div. of Taxation*, 908 A.2d 176 (N.J. 2006), cert. denied, 127 S.Ct. 2974 (2007); see also, *Geoffrey, Inc. v. Comm’r Revenue*, No.

credit cards and have accounts receivables in other states.³³ The question that must be decided is whether the imposition of a business activity tax upon a taxpayer without any physical presence in the state unduly burdens interstate commerce. The cases decided to date have not provided a clear answer to this question. In *Lanco*, the taxpayer was an intangible holding company that licensed the use of its trademarks to related retail stores but had no physical presence in New Jersey.³⁴ The intangible holding company was able to escape all taxation on the royalty income paid to it if New Jersey could not impose tax. The New Jersey Supreme Court ultimately held that physical presence was not required to subject the company to the income-based tax.³⁵ The Court acknowledged the debate over the proper standard that may be applied by states but then concluded, “Simply put we do not believe that the Supreme Court intended to create a universal physical presence requirement for state taxation under the Commerce Clause.”³⁶

In *MBNA*, the issue before the court was whether a bank in the business of issuing and servicing credit cards could be subject to the tax merely based on economic presence in the state.³⁷ Prior to the *MBNA* case, the economic presence nexus cases had dealt with intangible holding companies. Those cases can be distinguished as thinly disguised arguments for taxing the in-state presence of the intangibles and are often not considered true economic presence nexus cases. *MBNA* had no employees or property in West Virginia but could attribute over \$18 million in gross receipts to West Virginia customers for the years in question.³⁸ The West Virginia Office of Tax Appeals held that imposing an income-based tax on *MBNA*, a business with no physical presence in the state, violates the Commerce Clause of the United States Constitution.³⁹ The West Virginia Supreme Court, 6 to 1, held that it did not.⁴⁰ The Court provided a number of reasons for its decision. First, it found that *Quill*'s physical presence test was based primarily on *stare decisis* which does not apply to business activity taxes.⁴¹ Second, the *Quill* court limited its holding to sales and use taxes.⁴² Third, the Court found that the compliance burden of paying franchise and income taxes

C271816 (Mass. App. Tax Bd. July 24, 2007); *Praxair Tech, Inc. v. Division of Tax'n*, No. 007445-05 (N.J. Tax Ct. June 18, 2007).

33. See *MBNA*, 640 S.E.2d 226. See also discussion, *supra* note 15; *Capital One Bank v. Comm'r of Revenue*, No. C262391 and No. C262598 (Mass. App. Tax Bd. June 22, 2007).

34. *Lanco*, 908 A.2d at 176-77.

35. *Id.* at 177.

36. *Id.*

37. *MBNA*, 640 S.E.2d at 228-229.

38. *Id.* at 227-88.

39. *Id.* at 228.

40. *Id.* at 236.

41. *Id.* at 232.

42. *Id.*

was less than collecting and paying use tax.⁴³ Finally, the Court found that the physical presence test “makes little sense in today’s world.”⁴⁴ In place of the bright line physical presence test of *Quill*, the New Jersey Supreme Court adopted a “significant economic presence test” to determine substantial nexus under the Commerce Clause.⁴⁵ This test relies primarily on purposeful direction of activities into the state so that only income made by accident would avoid triggering jurisdiction to tax.⁴⁶ The Court found that continuous and systematic solicitation by telephone and mail, plus significant gross receipts (\$18 million) met the significant economic presence test.⁴⁷ These state cases indicate that states may be more willing to push an economic presence test; however, whether such standards meet constitutional muster cannot be definitively answered until guidance is provided by the United States Supreme Court.

IV. JURISDICTION TO TAX – MBT STATUTORY NEXUS STANDARDS

The MBT asserts broad jurisdiction to impose tax and adopts an economic presence test. Section 200 of the Act provides that, except to the extent otherwise provided under the law, a taxpayer has substantial nexus with Michigan if the taxpayer meets either of two primary nexus standards: physical presence or active solicitation.⁴⁸ First, the physical presence standard is satisfied by any person with physical presence within Michigan for more than one day.⁴⁹ Physical presence is any activity by an employee, agent or independent contractor acting in a representative capacity.⁵⁰ Second, the active solicitation standard is satisfied by any person that actively solicits business in the state and has apportioned gross receipts greater than \$350,000.⁵¹ Taxpayers that are subject to the business income tax are specifically subject to that tax only if imposition of the tax is not prohibited by several sections of federal law.⁵²

The substantial nexus test of Section 200 is declared to apply to all taxpayers under the Act.⁵³ This means that financial institutions potentially subject to the franchise tax on net capital must determine substantial nexus under the physical presence and active solicitation tests like other business entities. Under the plain language of the statute,

43. *MBNA*, 640 S.E.2d at 233-34.

44. *Id.* at 234.

45. *Id.* at 234.

46. *Id.*

47. *Id.* at 235-36.

48. MICH. COMP. LAWS ANN. § 208.1200 (West 2008).

49. MICH. COMP. LAWS ANN. § 208.1200(1) (West 2008).

50. MICH. COMP. LAWS ANN. § 208.1200(3) (West 2008).

51. MICH. COMP. LAWS ANN. § 208.1200(1) (West 2008).

52. *See* 15 U.S.C. §§ 381-384 (2008).

53. MICH. COMP. LAWS ANN. § 208.1200(1) (West 2008).

insurance companies subject to the gross direct premiums tax also appear to be subject to the “substantial nexus” test. However, under the McCarran-Ferguson Act, Congress has removed Commerce Clause protection from insurance companies.⁵⁴ Accordingly, an insurance company need only meet Due Process nexus standards to fall within Michigan’s jurisdiction to tax.

V. ACTIVE SOLICITATION STANDARD

One of the more highly controversial areas of the nexus standard is the imposition of tax on persons who do no more than “actively solicit” sales in the state and have more than \$350,000 in gross receipts sourced to Michigan.⁵⁵ The law specifically provides that “actively solicits” be defined by the Department of Treasury through written guidance and applied prospectively.⁵⁶ The purpose of the prospective application standard was to avoid the situation where the Department is retroactively changing the nexus standard on businesses.⁵⁷ On December 28, 2007, the Department issued Revenue Administrative Bulletin 2007-6 defining “actively solicits” just before the effective date of the MBT⁵⁸ “Actively solicits” is defined as purposeful solicitation of persons within Michigan.⁵⁹ Solicitation is defined as: (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly or implicitly invite an order, but are entirely ancillary to requests for an order.⁶⁰ This definition of “solicitation” replicates the definition adopted by the Multistate Tax Commission to interpret activities protected under 15 U.S.C. § 381.⁶¹ The result of this definition of “solicitation” is that insurance activities protected by 15 U.S.C. §381 are not subject to the business income tax portion of the MBT while those same activities will create substantial nexus and subject the

54. 15 U.S.C. § 1011, *et seq.* (2008).

55. MICH. COMP. LAWS ANN. § 208.1200(1) (West 2008).

56. MICH. COMP. LAWS ANN. § 208.1200(2) (West 2008).

57. A number of businesses had been caught by surprise when the Department retroactively changed its application of the SBT nexus standard under Revenue Administrative Bulletin 98-1. *See* J.W. Hobbs Corp v. Dep’t of Treasury, 706 N.W.2d 460 (Mich. Ct. App. 2005); *see also* Int’l Home Foods, Inc. v. Dep’t of Treasury, 708 N.W.2d 711 (Mich. Ct. App. 2005), *rev’d*, 725 N.W.2d 458 (Mich. 2007).

58. Mich. Dep’t Treasury, *Michigan Business Tax – “Actively Solicits” Defined*, MICH. REV. ADMIN. B. 2007-6 (Dec. 28, 2007), *available at* <http://michigan.gov> (accessed from homepage by entering “RAB 2007-6” into the Search box) (last visited June 10, 2008) [hereinafter Mich. Rev. Admin. B. 2007-6].

59. *Id.* at 1.

60. *Id.*

61. MULTISTATE TAX COMM’N., STATEMENT OF INFORMATION CONCERNING PRACTICES OF MULTISTATE TAX COMMISSION AND SIGNATORY STATES UNDER PUBLIC LAW 86-272 (3d rev. July 27, 2001), *available at* <http://www.mtc.gov> (accessed from homepage by entering “Public Law 86-272” into Search window) (last visited June 10, 2008).

taxpayer to liability under the modified gross receipts tax portion of the MBT.⁶² Further, solicitation is stated to be purposeful when it is directed at or intended to reach persons within Michigan or the Michigan market.⁶³

The Department provides a series of examples of active solicitation as including (1) the use of mail, telephone and email; (2) advertising via print, radio, internet, television, and other media; and (3) maintenance of an internet site over or through which sales transactions occur with persons within Michigan.⁶⁴ In evaluating whether an activity constitutes active solicitation the Department will look to “the quality, nature, and magnitude of the activity based on a facts and circumstances basis.”⁶⁵

The same standards used to determine nexus for out-of-state taxpayers will be applied to determine whether a Michigan taxpayer is taxable in another state and may apportion its tax base.⁶⁶ One advantage of the lower active solicitation standard is that many Michigan businesses that could not apportion their income under the SBT may be eligible to apportion sales if the business “actively solicits” customers in other states.⁶⁷ Any taxpayer that “actively solicits” in another state may apportion its tax base, irrespective of whether the state where the solicitation occurs imposes a tax.

Until the U.S. Supreme Court provides guidance on the limitations of states to impose business activity taxes under the Commerce Clause, one cannot know if the definition of “actively solicits” is constitutional or not. The standard articulated is more of a Due Process nexus standard found in the prior decisions of *Quill*⁶⁸ and *Burger King Corp.*⁶⁹ Moreover, the definition of “actively solicits” does not seem to require much activity. For example, maintenance of an internet site over which a Michigan resident can place an order does not necessarily suggest that the internet seller is “purposefully” directing its activities to the Michigan marketplace. Federal courts have found that placing an Internet advertisement on a computer server located in Missouri was insufficient to create a personal jurisdiction nexus in New York.⁷⁰ In addition, the standards articulated seem calculated to create Due Process nexus, but do not acknowledge that any greater presence other than \$350,000 of apportioned gross receipts is required to meet the Commerce Clause

62. Mich. Rev. Admin. B. 2007-6, *supra* note 57, at 2.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. MICH. COMP. LAWS ANN. § 208.1301(West. Supp. 2007) (providing that a taxpayer may apportion if another state would have jurisdiction to impose a tax of the type provided under the MBT).

68. *Quill*, 504 U.S. 298.

69. *Burger King Corp.*, 471 U.S. 462.

70. *Bensusan Restaurant Corp v. King*, 937 F. Supp. 295 (S.D.N.Y. 1996), *aff'd*, 126 F.3d 25 (2d Cir. 1997).

nexus standard. The Department's definition of "actively solicits" has been criticized for failing to recognize passive solicitation and passive advertisement that should not create nexus.⁷¹ Given that the Supreme Court in *Quill* specifically indicated that the two clauses had different purposes, will the Court uphold the same tests for both?

Michigan courts have historically interpreted the Commerce Clause nexus standard as a physical presence standard. In *Gillette v. Dep't. of Treasury*,⁷² once the Court of Appeals determined that there were no federal statutory limitations on Michigan's jurisdiction to impose the SBT,⁷³ the court analyzed the constitutional restrictions. The Court applied the *Quill* physical presence standard that the presence in a state of a small sales force, plant, or office may be sufficient to establish a substantial nexus for Commerce Clause purposes.⁷⁴ Subsequent Michigan court decisions have all cited the physical presence standard as the applicable standard for Commerce Clause nexus.⁷⁵ It is not clear whether Michigan courts, when asked to determine the constitutionality of the "active solicitation" nexus standard, will abandon the physical presence standard. Not all state courts have upheld an economic presence standard applied by its taxing authorities.⁷⁶ An additional unanswered question is whether the "active solicitation" standard is applicable to a gross receipts tax. In other words, is a gross receipts tax similar enough to a use tax that the *Quill* physical presence nexus standard should apply? The U.S. Supreme Court has applied a physical presence nexus test to Washington's business and occupations tax – a gross receipts tax.⁷⁷ However, these cases may be a historically anomaly because at the time the cases were argued no state was asserting an economic presence nexus argument. It is a fundamental rule of law that the courts do not answer questions not put before them. More recently, the New Mexico Supreme Court had the opportunity to apply an economic presence nexus test to its gross receipts and income taxes in *Kmart Corp. v. Taxation and Revenue*

71. Letter from COST Tax Counsel Todd A. Lard to Dale Vettel, Director Tax Policy Bureau, Michigan Department of Treasury, (Dec. 18, 2007), available at <http://www.statetax.org> (accessed from homepage by entering "Actively Solicits MI" into Search box) (last visited June 10, 2008).

72. 497 N.W.2d 595 (Mich. Ct. App. 1993).

73. *Id.* at 597-99.

74. *Id.* at 600.

75. *See, e.g., Rayovac Corp. v. Dep't. of Treasury*, 691 N.W.2d 57 (Mich. Ct. App. 2004); *Syntex Laboratories v. Dep't of Treasury*, 590 N.W.2d 612 (Mich. Ct. App. 1998). *See also Fluor Enterprises Inc. v. Dep't of Treasury*, 730 N.W.2d 722 (Mich. 2007) (Kelly, J. concurring) (holding that physical presence is required for taxing authority to exist).

76. *See, e.g., J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999);

77. *Standard Pressed Steel v. Wash. Dep't of Revenue*, 419 U.S. 560 (1975); *Tyler Pipe Industries, Inc. v. Wash. Dep't of Revenue*, 483 U.S. 232 (1987).

*Dep't.*⁷⁸ The court let stand the lower court ruling that an economic nexus standard applied to the New Mexico income tax but did not apply that same standard to its gross receipts tax.⁷⁹ Instead, the court narrowly applied statutory language to find a lack of jurisdiction.⁸⁰ Michigan is not alone in asserting an economic presence nexus standard for its gross receipts tax. Ohio asserts nexus is created for its gross receipts tax by sales of over \$500,000.⁸¹ In sum, the “active solicitation” nexus standard raises a myriad of questions. No answers will be forthcoming anytime soon, but challenges to the standard are certain.

VI. PHYSICAL PRESENCE STANDARD

Any person with a physical presence within Michigan for more than one day has nexus.⁸² Physical presence means any activity by an employee, agent, or independent contractor acting in a representative capacity.⁸³ Activities of a professional providing service in a professional capacity or other service providers do not constitute nexus, if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in the state.⁸⁴ The physical presence standard is clearly constitutional as discussed above. The Michigan Department of Treasury has stated that the standards discussed under the Revenue Administrative Bulletin 1998-1,⁸⁵ will be used to apply the MBT physical presence standard. The minimum days allowed in the state is now reduced to one day, but the attribution of contact by agents, independent contractors, or representatives working on behalf of the company to create nexus will apply and provide meaningful instruction for taxpayers. The Department has ruled that each of the following activities conducted in Michigan constitutes nexus creating activity under the physical presence standard: repossessing property, investigating creditworthiness, handling complaints, and collecting delinquent accounts; as well as “operating” any property located in Michigan on which an entity or person has foreclosed a mortgage or security interest.⁸⁶ The Michigan courts have

78. *Kmart Corp. v. Taxation and Revenue Dep't*, 131 P.3d 22 (N.M. 2005).

79. *Id.* at 23. The Court ordered the lower court's opinion recorded concurrently with its own opinion. See *Kmart Properties, Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27, 36-40 (N.M. Ct. App. 2002) (holding physical presence or its functional equivalent was necessary to create substantial nexus when the state seeks to impose a gross receipts tax).

80. *Kmart Corp.*, 131 P.3d at 27.

81. OHIO REV. CODE ANN. § 5751.01(I)(3) (West 2006).

82. MICH. COMP. LAWS ANN. § 208.1200(1) (West 2008).

83. MICH. COMP. LAWS ANN. § 208.1200(3) (West 2008).

84. *Id.*

85. Mich. Dep't. of Treas., *Single Business Nexus Standards*, MICH. REV. ADMIN. B. 1998-1 (Feb. 24, 1998) available at <http://www.michigan.gov> (accessed from homepage by entering “1998-1” into a Search box) [hereinafter Mich. Rev. Admin. B. 1998-1].

86. See Mich. Rev. Admin. Bul. 1998-1, *supra* note 84; Michigan Department of Treasury, *Single Business Tax Questions and Answers Volumes I-XIV*.

held that physical presence nexus includes the in-state presence of resident employee sales solicitors, inventory, leased property, independent contractor sales solicitors, and the temporary presence of employees or representatives.⁸⁷ There is little in the way of in-state physical presence that will not create substantial nexus under the MBT although there will undoubtedly continue to be disputes over the limits of attributional nexus.

VII. FEDERAL STATUTORY RESTRICTIONS ON MICHIGAN'S TAXING JURISDICTION

In general, Public Law 86-272 (P.L. 86-272) prevents Michigan from imposing a business income tax on a business entity whose contacts with a state are limited to solicitation of sales by either employees or independent contractors, under certain circumstances.⁸⁸ P.L. 86-272 prohibits any state from imposing a net income tax on the income derived within such state by any person from interstate commerce, if the only business activities within such state are solicitation of sales by nonresident employees or independent contractors. Under P.L. 86-272, "net income tax" is defined as "any tax imposed on, or measured by, net income."⁸⁹

P.L. 86-272 was enacted to reverse the results in the cases of *Northwestern States Portland Cement Co. v. State of Minnesota*,⁹⁰ and *Brown-Forman Distillers Corp. v. Collector of Revenue*.⁹¹ In both of these cases, the U.S. Supreme Court found that the in-state presence of missionary men soliciting sales on behalf of out-of-state entities created sufficient nexus to support imposition of a corporate income tax.⁹² The purpose of the legislation was to prohibit imposition of a net income tax, or a tax measured by net income, on income derived within the State by any person from interstate commerce in that limited situation.⁹³ However, the bill had no intent to expand state power to tax income derived from interstate commerce.⁹⁴ There are no federal cases that interpret the definition of "net income tax" under 15 U.S.C. Section 383. Whether a tax constitutes a "net income tax" has been interpreted only by state courts.

87. *Gillette Co. v. Dep't of Treasury*, 497 N.W.2d 595 (Mich. Ct. App. 1993); *see also Superior Industries v. Dep't of Treasury*, No. 230853 (Mich. Tax. Trib. 1998).

88. Pub. L. No. 86-272 (1959), codified at 15 U.S.C. § 381 *et seq.*

89. 15 U.S.C. § 383.

90. 358 U.S. 450 (1959).

91. 359 U.S. 28 (1959).

92. *Northwestern States Portland Cement Co.*, 358 U.S. 450 (1959); *see also Brown-Forman Distillers Corp.*, 359 U.S. 28 (1959).

93. 1959 U.S.C.C.A.N. 2552, 2560.

94. *Id.* at 2551.

The business income tax (BIT) statute recognizes that P.L. 86-272 limits the applicability of the BIT.⁹⁵ Thus, any out-of-state company that limits its contacts with Michigan to solicitation of sales of tangible personal property by nonresident employees or independent contractors is not subject to the BIT. Solicitation of sales is defined as speech or conduct that explicitly or implicitly invites, an order and activities, that are entirely ancillary to requests for an order.⁹⁶ The BIT has been interpreted to apply the protections of P.L. 86-272 to non-U.S. companies.⁹⁷ The sellers of services and intangibles do not receive the protection of P.L. 86-272 and will be subject to the BIT based on solicitation activities. The modified gross receipts tax does not include any reference to P.L. 86-272 and, presumably because the gross receipts tax is not a true net income tax, the Department will take the position that P.L. 86-272 does not apply.

VIII. SMALL BUSINESS CREDIT TAXPAYERS AND P.L. 86-272

One of the interesting questions under the MBT is whether P.L. 86-272 will apply to limit the ability of Michigan to tax companies eligible for the small business credit. Under the MBT, the small business credit works to tax a qualified small business at a rate of 1.8 percent on modified federal taxable income.⁹⁸ In addition, the number of businesses that are eligible is expanded as businesses with gross receipts of up to \$20 million will qualify.⁹⁹ Adjusted business income may not exceed \$1.3 million and owner/operators cannot receive compensation or distributable shares of income in excess of \$180,000.¹⁰⁰ Under P.L. 86-272, "net income tax" is defined as "any tax imposed on, or measured by, net income."¹⁰¹ The small business credit is defined as "a credit against the tax imposed under this act . . . [in] the amount by which the tax imposed under this act exceed \$1.8 percent of adjusted business income."¹⁰² Adjusted business income is federal taxable income subject to the additions and subtractions under section 201.¹⁰³ Thus, the small business taxpayer is paying tax on net income and may be able to claim the protection of P.L. 86-272.

95. MICH. COMP. LAWS ANN. § 208.1201(1) (West 2008).

96. See discussion, *supra* notes 57-64 and accompanying text; see also Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992).

97. Mich. Dept. of Treasury, FAQ Michigan Business Tax at N9, available at <http://www.michigan.gov> (accessed from homepage by entering "N9" into Search box) (last visited June 10, 2008).

98. MICH. COMP. LAWS ANN. § 208.1417(4) West 2008).

99. MICH. COMP. LAWS ANN. § 208.1417(1) (West Supp. 2007).

100. MICH. COMP. LAWS ANN. §§ 208.1417(1)-(2) (West Supp. 2007).

101. 15 U.S.C.A. § 383 (2008).

102. MICH. COMP. LAWS ANN. § 208.1417(4) (West 2007).

103. MICH. COMP. LAWS ANN. §§ 208.1105(2), 208.1201(2) (West 2008).

Many states have looked to how the tax functions operationally to determine if it is a “net income” tax entitled to the limitations under P.L. 86-272. The functional test looks to what is the measure that is actually taxed by the tax. For example, the fact that items of expense and capital outlay were included in the SBT base have uniformly been held to be the antithesis of a tax on, or measured by, net income. In *Appeal of Dayton Hudson Corp.*,¹⁰⁴ the California Board of Equalization held that the critical inquiry for determining whether a tax is measured by something other than income was whether the tax base included cost of goods sold or a return of capital.¹⁰⁵ Thus, the Board held that the Michigan SBT includes an element of tax on return of capital and, therefore, is not a tax on gross or net income.¹⁰⁶ In *Kelly Service*, the general operation of the tax was held to be determinative of the nature of the tax.¹⁰⁷ The Board noted that deductibility of a tax varies based on each taxpayer only if the tax in question is measured by different standards depending on the activity undertaken by the taxpayer.¹⁰⁸ Under this type of standard a small business taxpayer may argue that as long as its activities meet the criteria for the credit, the taxpayer is being taxed under only a net income tax. Similarly, in *Kellogg Sales Co. v Dep’t of Revenue*,¹⁰⁹ the Oregon Tax Court held that a “net income tax” is one that taxes gain realized after payment of expenses necessary to earn income. Thus, the Oregon Tax Court held that the SBT was not a tax measured by or on net income or profits because it added back wages.¹¹⁰ Again, under such a standard, a qualifying small business taxpayer could claim to be subject to a net income tax.

IX. UNITARY BUSINESS GROUP

The MBT defines a taxpayer as a person or a “unitary business.”¹¹¹ Accordingly, when determining whether a person has substantial nexus, exceeds the filing threshold, and/or has a responsibility to pay MBT, one

104. *In re Appeal of Dayton Hudson Corp.*, No. 94-S BE-003, (Cal. State Bd. of Equalization Feb. 3, 1994), available at <http://www.boe.ca.gov> (accessed from homepage by entering “Appeal of Dayton Hudson Corp” into Search box) (last visited June 10, 2008).

105. *Id.* at 3-4.

106. *Id.* See also *First Chicago NBD Corp. v. Indiana Dep’t of State*, 708 N.E.2d 631 (TC. Ind. 1999) (holding that the fact that corporate costs of goods sold were added to the tax base determined that the SBT is not a tax based on or measured by income, irrespective of the fact that federal taxable income was the starting point).

107. *In re Appeal of Kelly Services, Inc.*, No. 97-SBE-010 (Cal. State Bd. of Equalization May 9, 1997) available at <http://www.boe.ca.gov> (accessed from homepage by entering “Appeal of Kelly Services” into Search box) (last visited June 10, 2008).

108. *Id.*

109. 10 Or. T.C. 480 (1987), *aff’d*, 766 P.2d 1029 (Or. 1988).

110. *Accord Willamette Indus. v. Dep’t. of Rev.*, 12 Or. T.C. 291 (1992).

111. MICH. COMP. LAWS ANN. § 208.1117(5) (West 2008).

must first determine whether the person is a member of a unitary business group. If so, all determinations are made at the unitary business group level and all references to taxpayer are applied to the unitary business group.¹¹²

A unitary business group is defined as a group of United States persons, other than a foreign operating entity.¹¹³ A unitary business group may include any United States person under the Act, including corporations, partnerships, and limited liability companies. A United States person is a United States citizen or resident; a domestic partnership, a domestic corporation, any estate other than a foreign estate; and any trust under the supervision of a United States court for which a United States person has authority to control decisions of the trust.¹¹⁴ A unitary business group must meet the control test and one of two alternative relationship tests: (1) flow of value test, or (2) contribution and dependency test. Under the control test, one member of the unitary group must own or control more than a 50 percent ownership interests with voting rights, or the equivalent of voting rights.¹¹⁵ The Michigan Department of Treasury has released to the public via its website a number of frequently asked questions and answers (FAQ) to provide guidance on its interpretation of the MBT.¹¹⁶ Under FAQ U6,¹¹⁷ the Department has stated that it will use as guidance the attribution rules of I.R.C. Section 318 or “analogous authority” to determine indirect or constructive ownership and control. I.R.C. Section 318 specifically applies only to corporate stock ownership; however, the Department has indicated that it will apply the Section 318 principles “to all forms of entities subject to the MBT.”¹¹⁸

Under the first of the two alternative relationship tests, members are unitary if there is a flow of value between the members. Flow of value has been defined by the Department as created by functional integration, centralized management, or economies of scale.¹¹⁹ Functional integration

112. MICH. COMP. LAWS ANN. § 208.1511 (West Supp. 2007).

113. MICH. COMP. LAWS ANN. § 208.1117(6) (West 2008). *See also* MICH. COMP. LAWS ANN. § 208.1109(5) (West 2008) (noting that a foreign operating entity is a United States person that would otherwise be part of a unitary group; that has substantial operations outside of the U.S., Puerto Rico and any territory of the U.S.; and at least 80 percent of the income is active foreign income under I.R.C. § 861(c)(1)(B)).

114. MICH. COMP. LAWS ANN. § 208.1117(7) (West 2008); I.R.C. § 7701(a)(30) (2006).

115. MICH. COMP. LAWS ANN. § 208.1117(6) (West 2008).

116. Frequently Asked Questions, Michigan Business Tax, Mich. Taxes, Dep’t of Treasury, *available at* <http://www.michigan.gov> (accessed from homepage by entering “FAQ” into Search box) (last visited June 10, 2008).

117. U6, Frequently Asked Questions, Michigan Business Tax, Mich. Taxes, Dep’t of Treasury, *available at* <http://www.michigan.gov> (accessed from homepage by entering “U6” into Search box) (last visited June 10, 2008).

118. *Id.*

119. U33, Frequently Asked Questions, Michigan Business Tax, Mich. Taxes, Dep’t of Treasury, *available at* <http://www.michigan.gov> (accessed from homepage by entering “U33” into Search box) (last visited June 10, 2008).

is demonstrated through common programs or systems and shared information or property.¹²⁰ Centralized management comes from common management or directors, shared staff functions, and business decisions made for the group rather than separately by each member.¹²¹ Economies of scale include centralized business functions and pooled benefits or insurance.¹²² The Department has stated that vertically or horizontally integrated businesses, conglomerates, parent companies with their wholly owned subsidiaries, and entities in the same general line of business commonly exhibit a flow of value.¹²³ Flow of value must be more than the mere flow of funds arising out of passive investment.¹²⁴ Under the second alternative relationship test, businesses must be integrated with, are dependent upon, or contribute to each other (hereinafter the integration, dependency or contribution test). This test is commonly satisfied when one entity finances the operations of another or when there exist intercompany transactions, including financing.¹²⁵

The MBT requires mandatory unitary filing.¹²⁶ Thus, if any member of the unitary group has nexus under the active solicitation or physical presence nexus tests, the entire unitary group is subject to filing for the MBT. All of the sales of all members of the unitary business group are required to be reported in the numerator of the sales apportionment factor.¹²⁷ This is known as the “Finnigan Rule” based on the California case establishing this rule.¹²⁸ Other unitary states have taken the position that if a member of the unitary group does not have nexus with the state or is protected from imposition of the tax by P.L. 86-272, sales of such member are not included in the numerator of the sales factor. This position is known as the “Joyce Rule” based on the case establishing this rule.¹²⁹ Businesses have criticized Michigan’s adoption of the Finnigan Rule arguing that it unlawfully taxes companies with no nexus with Michigan that are specifically protected from imposition of the BIT by P.L. 86-272. The New York Court of Appeals has recently rejected a

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. MICH. COMP. LAWS ANN. § 208.1511 (West 2008).

127. MICH. COMP. LAWS ANN. § 208.1303(2) (West 2008).

128. *In re* Appeal of Finnigan Corp., No. 88-SBE-022-A (Cal. State Bd. of Equalization 1990), available at <http://www.boe.ca.gov> (accessed from homepage by entering “Appeal of Finnigan Corp” into Search box) (last visited June 10, 2008).

129. *In re* Appeal of Joyce, Inc., 66-SBE-070 (Cal. State Bd. of Equalization 1966), available at <http://www.boe.ca.gov> (accessed from homepage by entering “Appeal of Joyce” into Search box) (last visited June 10, 2008). California returned to the Joyce Rule in *In re* Appeal of Huffy Corp., 99-SBE-005 (Cal. State Bd. of Equalization 1999), available at <http://www.boe.ca.gov> (accessed from homepage by entering “Appeal of Huffy Corp” into Search box) (last visited June 10, 2008).

similar argument in *Disney Enterprises*.¹³⁰ The Court of Appeals rejected Disney's argument that including the non-nexus subsidiary's income in its apportionment formula when determining the combined group's taxable state income constituted a tax.¹³¹ The court held that the department was not imposing a tax but that it was trying to best measure the combined group's taxable New York activities.¹³² The court said that unitary reporting is intended to reflect the economic reality of a group as a whole, taking into account multi-jurisdictional activity.¹³³ Next, the court held that inclusion of the nontaxpayer sales did not violate P.L. 86-272. The court concluded that P.L. 86-272 was not intended to prevent inclusion of state income generated by the unified activities of a corporate giant such as Disney.¹³⁴ Even with this recent decision, it is likely that the adoption of the Finnegan Rule will be challenged.

X. CONCLUSION

The Michigan Business Tax has thrust Michigan into the forefront of nexus controversy with the adoption of the "active solicitation" nexus standard. This untested standard is bound to be challenged by taxpayers objecting to its broad reach. Even those taxpayers trying to comply with the standards will have difficulty determining what, if any, activities do not subject an out-of-state company to nexus. The physical presence standard is not without impact as questions relating to attributional nexus will continue to arise. Taxpayers will also need to learn the intricacies of P.L. 86-272 to determine when the limited protection of this federal law will apply. Nexus determinations in Michigan now have added import because the determination that a company has nexus may expose an entire unitary business group to liability under the MBT.

130. *Disney Enterprises, Inc. v. Tax Appeals Tribunal*, 888 N.E.2d 1029 (N.Y. 2008).

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.*