SFA BILL ANALYSIS

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House Bill 4398 (Substitute S-3)
Sponsor: Representative H. Lynn Jondahl
House Committee: Taxation
Senate Committee: Finance

Date Completed: 5-26-87

RATIONALE

A business that does business in more than one state must calculate its state taxes by using the various states' apportionment formulas, to determine that portion of its total tax base taxable in each state. Under Michigan's Single Business Tax Act, a firm's single business tax (SBT) liability is calculated by adding profits, labor costs, interest, royalties and certain other items. The base is then apportioned to Michigan by multiplying the tax base by the average of the firm's property, payroll and sales attributable to Michigan. This formula, commonly known as the three-factor formula, is used in some form by 32 states. The formula is calculated in the following manner:

$$\text{Apportionment Factor} = \left| \frac{\text{Property in MI}}{\text{All Property}} + \frac{\text{Payroll in MI}}{\text{All Payroll}} + \frac{\text{Sales in MI}}{\text{All Sales}} \right| \text{ divided by 3}$$

In recent years, two firms with headquarters in other states used an alternative calculation of their Michigan SBT base, producing a lower tax liability, and their method was upheld by the Court of Appeals. Jones & Laughlin Steel and Wilson Foods computed their tax bases, excluding compensation, and apportioned this total using the three factor formula. Then they added their actual compensation in Michigan. Because actual Michigan compensation was less than total compensation apportioned to Michigan, the court approved the alternative calculation, saying the three-factor average on the entire tax base resulted in an excessive amount of compensation attributed to Michigan. The firms based their claim on Section 69 of the Single Business Tax Act, which allows taxpayers to petition the State Revenue Commissioner for an alternate method of apportioning the taxpayer's business activity in Michigan if the Act's apportionment formula does not "fairly represent" the extent of that activity. The result of the court's decision in Jones & Laughlin Steel Corporation v Department of Treasury, 145 Mich App 405 (1985), is that many out-of-state taxpayers are appealing their past taxes based on a separate allocation of compensation or other components of the tax base. Recent reports that over 200 firms have filed amended returns have prompted some people to call for legislation to address the issue.

CONTENT

The bill would amend the Single Business Tax Act to create a presumption of fairness of the Act's apportionment provisions in instances in which a taxpayer petitions the Revenue Commissioner for an alternate method of calculation, and to specify that the Legislature intended that relief from the apportionment formula be granted only under extraordinary circumstances.

The bill states that the apportionment provisions of the Act would represent fairly the extent of a taxpayer's business activity in this State, taken as a whole and without a separate examination of the specific components of the tax base, unless it could be demonstrated that the business activity attributed to the taxpayer in this State was "out of all appropriate proportion" to the actual business transacted in Michigan and led to a "grossly distorted result".

A taxpayer's business activity would be presumed to be fairly represented by the three-factor formula if: the adjusted tax base calculated using that formula were less than the apportioned tax base calculated by multiplying the total SBT base by the percentage of the firm's total sales attributable to Michigan; or, the adjusted tax base were less than an apportioned base computed by using the apportionment formula prescribed for a corporate income tax or franchise tax in the firm's domicile. (A firm's "domicile" would be defined as the state in which the sum of the firm's payroll factor and property factor were greatest.) If a firm failed to satisfy either of these qualifications, however, the firm's business activity would not be presumed not to be fairly represented.

The filing of a return or an amended return could not be considered a petition for determining whether the apportionment provisions of the Act fairly represented the taxpayer's business activity in the State

Further, the bill specifies that its provisions would be "curative, expressing the original intent of the legislature that the single business tax...is an indivisible value added tax and not a combination or series of several smaller taxes and that relief from...[the act's three-factor formula] should be granted only under extraordinary circumstances". The bill also states that it would clarify existing procedures and standards for granting relief.

MCL 208.69

FISCAL IMPACT

The bill would result in an indeterminate amount of State revenue gain, by reversing the impact of the Court of Appeals ruling in Jones & Laughlin Steel Corp. v Department of Treasury. That decision upheld the alternative calculation of the taxpayers' SBT base, which produced a lower tax liability. Since that decision, over 200 firms have filed amended returns, requesting similar tax treatment. Although all amended returns have been denied by the Treasury, approximately 200 firms have already filed cases with the tax tribunal. The revenue loss from these 200 firms is estimated at $90 million, which can be taken as the lower boundary of the estimated revenue

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gain of House Bill 4398. The estimate of State revenue loss from the case is still uncertain. If all eligible firms filed amended returns, adjusting their tax by the new method, the revenue gain from House Bill 4398 would be much greater.

ARGUMENTS

Supporting Argument

The bill would reverse the effect of the Jones & Laughlin Steel Corporation v Department of Treasury decision, which created a potential windfall for out-of-state single business taxpayers at the expense of the State Treasury and Michigan employers. To be consistent, the Department of Treasury would have to apply the alternative calculation to all taxpayers whose actual Michigan compensation differs substantially from their apportioned compensation. This would result in significantly higher tax liabilities for Michigan companies who employ large numbers of people in this State, while rewarding out-of-state companies who benefit from sales in Michigan but provide few jobs for Michigan residents. By focusing on separate components of the tax base, the court decision ignored the integrated nature of the single business tax; the SBT is derived from corporate income tax statutes under which the specific components of a taxpayer's income cannot be separated. Further, the terms and definitions used in the bill reflect the constitutional standards set by the U.S. Supreme Court for relief from formulary apportionment.

Opposing Argument

The segment of the bill that would retroactively presume that the SBT is an indivisible value added tax, and not a combination of several smaller taxes, represents an unfair attempt to negate the Jones & Laughlin decision. Such an action would likely result in further, extended litigation that would challenge the constitutionality of the bill, and postpone settlement of the issue for years to come. Instead of changing the rules in the middle of the game, the Jones & Laughlin decision should be allowed to stand and the SBT Act should continue as interpreted. The effect of the bill could be to inhibit future investment in the State by out-of-state businesses if they feel they are being unfairly taxed, particularly if they have been given the right to apply for a refund on several years' taxes but find that right suddenly taken away.

Response: The bill is needed because the SBT is no longer uniformly applied to in-state and out-state firms. The effect of the Jones & Laughlin decision has been to construct a dual tax system: the one the Legislature enacted and the one the court created. The charge that the bill would not end litigation has no merit, because without legislation firms determined to press for refunds will do so and the State will likely challenge each claim. As for the contention that the bill could harm future investment in the State, it is probable that the firms will base investment decisions on several factors, including potential for profit, rather than solely on a dispute over the interpretation of a portion of a tax statute.

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