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## Michigan's New Apportioned Value Added Tax

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## I. Introduction

Michigan has a reputation for innovation in the design of its tax system. Back in 1976, it adopted its single business tax, which, like the Hall-Rabuska flat tax, was essentially an origin-based value added tax. Such a tax has the major disadvantage of imposing a tax on exports and exempting imports. Michigan repealed the SBT, effective at the end of 2007, and replaced it with four new taxes:

- a business income tax;
- a modified gross receipts tax (MGRT);
- a gross insurance premiums tax; and
- a bank capital tax on financial institutions.

This tax package is referred to as the Michigan business tax (MBT).

The MGRT is best characterized as an apportioned VAT. In contrast to the SBT, it is a destination-based tax. That is, the tax is imposed on imports and not on exports. The rate of the MGRT is low — only around 1 percent.

The MGRT generally is imposed on gross receipts, reduced by "purchases from other firms." That latter term is defined generally to include inventory purchased during the tax year, capital purchases, and material and supplies. That is, the taxpayer starts with its receipts and deducts, with a few exceptions, its inputs. The result is a tax on the value added by the taxpayer. Inputs also are taxed, but to the taxpayer selling the inputs. The goal is to tax all value added within the state.

Despite having "gross receipts" in its title, the Michigan MGRT is unlike the traditional state gross receipts taxes, such as Washington's business and occupation (B&O) tax or Ohio's new commercial activity tax (CAT).<sup>1</sup> The Ohio tax is described by the Ohio Department of Revenue as "an annual privilege tax measured by gross receipts on business activities in this state."<sup>2</sup> The Ohio CAT, like the B&O tax, is a pure business activities gross receipts tax, with no deduction for inputs. The Michigan tax is an entirely different animal.

***In contrast to an income tax, the MGRT offers a relatively stable revenue source because value added is a more stable tax base than income.***

In contrast to an income tax, the MGRT offers a relatively stable revenue source because value added is a more stable tax base than income. For example, General Motors has not earned any income in the last few years, but it has produced and sold

<sup>1</sup>See Ohio Rev. Code Ann. section 5751.02 (West 2008).

<sup>2</sup>See General Information on the Commercial Activity Tax (CAT), Ohio Department of Taxation, available at <http://tax.ohio.gov> (accessed from homepage by selecting the "Business" tab, then selecting "Ohio Taxes," then selecting "Commercial Activity Tax," then selecting "General Information") (last visited December 12, 2008).

goods in Michigan that would be taxable under the MGRT. A stable revenue source is important to Michigan, given the highly cyclical nature of the auto industry.

The package of tax changes flying under the MBT label included the four taxes mentioned above plus a combination of property tax cuts<sup>3</sup> and tax incentives intended to foster job creation. The property tax cuts and the tax incentives were intended to make Michigan more attractive for business investment. Like most, if not all, of the states, Michigan was trying to fashion its business taxes in a way that gave a competitive advantage to taxpayers conducting business activities within the state without running afoul of the U.S. Supreme Court's commerce clause jurisprudence.

Although the MGRT resembles a traditional, European-style VAT in many respects, it has some important features not found in a traditional VAT or in any known variation of that tax. The most important of those features is that the tax base is initially defined in terms of worldwide value added and then a portion of that base is apportioned to Michigan using a "sales-only" apportionment formula. Another special feature, found in only a few tax jurisdictions, is that assessment of the tax is made from the annual books of account of the taxpayers. A traditional VAT is a transactional tax, similar to a retail sales tax.

If Michigan is successful in administering this new tax, it may prove interesting to the many nations that have adopted a VAT tax and have found great difficulty auditing individual transactions. It also may be of interest to other states, given their current needs for additional revenue. Whether the tax is desirable depends on local considerations. Michigan preferred it to a 1 percentage point bump in its sales tax because the constitutional cap on the sales tax had been reached and, in any event, it was politically expedient to replace the SBT with a tax that could be characterized in public discourse as a business tax rather than a tax on consumers. Nei-

ther of those reasons deserves much weight as a matter of sound tax policy.

From a policy perspective, an advantage of the MGRT over the typical retail sales is that it has explicit and workable rules for avoiding the double taxation of business inputs. Also, the base is broader, including a much broader inclusion of receipts from the sale of services. As discussed below, the MGRT does permit a double tax to be imposed on some services, but that defect would not be terribly difficult to fix. Of course, a retail sales tax might be designed to avoid the double taxation of most business inputs and to include most services in the tax base. States have failed to fix the flaws in their retail sales tax primarily, but not exclusively, because of political rather than technical difficulties.

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The MGRT, as initially passed at the end of 2007, raised several concerns that we highlighted in our symposium article. We are pleased to see that the Michigan Department of Treasury issued guidance in October 2008 that addressed most of those concerns. Our concerns and the response of the Michigan tax authorities are discussed below.

This article addresses some major design issues that arise in fashioning a state VAT within the Supreme Court's commerce clause jurisprudence. Section II provides a general overview of the Michigan taxing scheme. Section III discusses its nexus rules, including its controversial "economic presence" test.

In Section IV, we discuss Michigan's novel method for apportioning the base of its VAT. It is this feature of the Michigan VAT that may be of particular interest to foreign governments seeking to administer a VAT based on the books of account of the taxpayer. Section V deals with the use of the unitary business concept in the context of a VAT. We express our disappointment at the water's-edge rules that Michigan has adopted, because of our concerns about the tax avoidance possibilities they present. We are pleased, nevertheless, to see the unitary business concept applied to limit the ability of taxpayers to use "entity isolation" techniques to avoid taxes on sales within a jurisdiction.

<sup>3</sup>The MBT provides a 24 mill reduction in the rate of personal property taxation on industrial personal property; a 12 mill reduction for commercial personal property; a refundable 35 percent credit against the MBT for personal property taxes paid on industrial personal property (replacing the 15 percent credit in the SBT); a refundable 23 percent credit for personal property taxes paid by telephone companies in 2008, reduced to 13.5 percent in later years; and a 10 percent refundable credit for personal property taxes on natural gas pipelines. Mich. Comp. Laws Ann. section 208.1413(1) (West Supp. 2007).

## II. Overview of the MGRT Statute

The MBT statute imposes a MGRT on every taxpayer with nexus in the state. That tax is imposed on the MGRT base, after allocation or apportionment to Michigan. The basic rate is 0.8 percent, increased by a surcharge of 21.99 percent, bringing the total tax rate of the MGRT to just under 1 percent.<sup>4</sup>

“Gross receipts” under the MGRT means the entire amount received by the taxpayer from any activity “whether in intrastate, interstate, or foreign commerce carried on for direct or indirect gain, benefit, or advantage to the taxpayer.” This broad definition indicates that the Legislature intended to cast a wide net.

“Taxpayer” includes individuals, firms, limited partnerships, limited liability partnerships, partnerships, joint ventures, associations, corporations, limited liability companies, estates, and trusts. It also includes a unitary business group, or any other group or combination of groups acting as a unit. Specifically excluded as taxpayers are the United States, states, political subdivisions, persons exempt under the Internal Revenue Code, nonprofit housing corporations, and farmer cooperatives. Also, a taxpayer earning gross receipts attributable to some agricultural activities is exempt regarding those gross receipts.

The MGRT base means a taxpayer’s gross receipts less purchases from other firms before apportionment. Purchases from other firms includes:

- inventory acquired during the tax year, including charges for such things as shipping that are treated as inventory costs;
- depreciable or amortizable assets, including the costs of fabrication and installation; and
- materials and supplies, including repair parts and fuel.

With some modest exceptions for services that are, in effect, purchased for resale, purchases of services are not deductible. They would be deductible under a normative VAT.

The statute provides other exclusions from the tax base that are appropriate to refine the definition of a gross receipt. For example, tax refunds and refunds from returned merchandise — essentially negative gross receipts — are excluded from that definition. A recent amendment to the statute provides that gross receipts attributable to the payment of the retail sales tax are excluded from the base of the MGRT.

Other exclusions from the definition of gross receipts are questionable because they are not required to define properly a gross receipt. Two notable exclusions are for the proceeds from the sale of

land and most capital assets, less any gain from the sale of those assets to the extent included in federal taxable income. The effect of this rule is to treat only the gains derived from those sales as taxable gross receipts. Also, presumably for administration reasons, the gains are taxable only if they have been included in federal taxable income. The inclusion of only net gains on some capital transactions is consistent with the denial of a deduction for the purchase of those assets under the adjustment for purchases from other firms. Of course, consistency also could be achieved by including the sales proceeds and deducting the initial purchases.

The MGRT applies to taxpayers “with nexus as determined under section 200.” That section provides that substantial nexus in Michigan exists if the taxpayer has a physical presence in Michigan for a period of more than one day during the tax year or if the taxpayer actively solicits sales in the state and has gross receipts of \$350,000 or more attributed to Michigan. The Michigan nexus rules are discussed in greater detail below.

The MGRT base (as well as the tax base of the business income tax) is apportioned for taxpayers whose business activities are subject to tax both within and outside Michigan by using a sales-only apportionment formula. The numerator of that formula is the total sales of the taxpayer in Michigan during the tax year, and the denominator is the total sales everywhere during that year. The apportionment rules are discussed in greater detail below. Taxpayers engaged in business only in Michigan are not subject to apportionment; they have all of their adjusted gross receipts *allocated* to Michigan.

The Michigan statute incorporates the concept of a unitary business, developed in the context of state corporate income taxes, into the MGRT. In general, commonly controlled firms operating a unitary business are treated as a single firm, and all transactions within the unitary group are ignored for purposes of the MGRT. Similar rules apply for purposes of the Michigan business income tax. The treatment of members of a unitary group of firms is addressed in greater detail below.

The MBT provides a panoply of new credits available to all MBT payers, including taxpayers under the MGRT. Those credits are intended to favor taxpayers with significant business operations in Michigan. The MBT also terminates some credits available under the SBT. A taxpayer with gross receipts no greater than \$700,000 is allowed a credit that eliminates a portion of its tax liability under the MBT. Thus the MGRT either exempts or provides concessions to businesses that might be characterized as small. The point of the credit is to avoid the so-called cliff problem that results when a dollar of additional gross receipts above the \$350,000 threshold causes the taxpayer to pay more than a dollar in tax.

<sup>4</sup>The actual combined rate is 0.976 percent.

Taxpayers (other than insurance companies and financial organizations) are not required to file a tax return or pay tax under the MBT if their allocated or apportioned gross receipts are less than \$350,000. The \$350,000 threshold corresponds with the economic nexus threshold of the same amount.

### III. Nexus to Tax

#### 1. Background

The gross receipts tax applies to taxpayers “with nexus” in Michigan. The statute does not define nexus, but instead provides two ways of satisfying *substantial* nexus: having a physical presence in Michigan for more than one day during the tax year, or actively soliciting sales in Michigan and having Michigan gross receipts of at least \$350,000. For convenience, we will refer to those alternatives as “physical presence” and “economic presence,” respectively.

Those two alternative grounds for nexus are best understood in the context of a debate raging among the states and taxpayers over the proper interpretation of the Supreme Court’s 1992 decision in *Quill Corp. v. North Dakota*.<sup>5</sup> That case concerned whether North Dakota could require Quill, an out-of-state mail-order house that had no outlets or sales representatives in the state, to collect a use tax on goods shipped to customers in North Dakota. Twenty-five years earlier, in *National Bellas Hess v. Illinois*,<sup>6</sup> the Court had ruled that a seller whose “only connection with customers in the State is by common carrier or the United States mail” lacked the requisite minimum contacts necessary for the state to be able to compel it to collect the use tax.

In *Quill*, the Court first held that the taxpayer “had purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits [the taxpayer] receives from access to the State.” It wasn’t enough, however, for Quill to have sufficient contacts (nexus) under the due process clause. The Court also required that Quill have nexus under the commerce clause. Latching onto dictum in *Complete Auto Transit v. Mississippi*,<sup>7</sup> the Court held that the remote vendor must have “a substantial nexus” with a state for the state to have the power to compel the vendor to collect the use tax.<sup>8</sup>

<sup>5</sup>504 U.S. 298 (1992).

<sup>6</sup>386 U.S. 753 (1967).

<sup>7</sup>430 U.S. 274 (1977).

<sup>8</sup>For a critical analysis of *Quill*, see Richard D. Pomp and Michael J. McIntyre, “State Taxation of Mail-Order Sales of Computers after *Quill*: An Evaluation of MTC Bulletin 95-1,” *State Tax Notes*, July 15, 1996, p. 177 (1996), *Doc 96-19908*, or 96 *STN 140-44*, excerpted in Richard D. Pomp and Oliver Oldman, *State and Local Taxation* (5th ed. 2005) at 9-71. See

(Footnote continued in next column.)

The Court adopted in *Quill* what it referred to as the “*Bellas Hess* rule,” meaning that physical presence will satisfy the substantial nexus requirement. The Court claimed that one benefit of the rule was that it provides a bright-line test that would reduce the likelihood of litigation. Furthermore, “a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals.” As the discussion below suggests, the substantial nexus line is not as bright as the Court may have intended.

#### 2. Substantial Nexus and Michigan’s One-Day Rule

The Michigan statute uses the term “substantial nexus” in defining its nexus standard, mirroring the term used in *Quill*. The Court, however, did not define substantial nexus. In acknowledging that the bright-line, physical presence test might appear artificial at its edges, the Court said that “whether or not a State may compel a vendor to collect a sales or use tax may turn on the *presence in the taxing State of a small sales force, plant, or office*.” That statement is hardly a clear statement of the law of nexus. It implies that a small sales force, plant, or office could constitute the kind of physical presence that the Court will accept as substantial nexus under the commerce clause. It does not indicate how small that sales force, plant, or office could be and still constitute substantial nexus, nor does it give any clue as to how long the sales force, plant, or office must exist in the state to constitute substantial nexus. Nor does it indicate that a sales force, plant, or office is required for nexus, rather than merely being sufficient for nexus. Those questions have been left for others to answer, at least for now.

The Michigan statute provides one possible answer to the duration question by defining substantial nexus as a “physical presence for more than one day.”<sup>9</sup> That answer is on the aggressive side, although not foreclosed by the language of *Quill*.

The statute is silent on the qualitative nature of the physical presence. Is mere physical presence for a day enough, or is there some implicit requirement that the physical presence advance the taxpayer’s business in some nontrivial way? For example, a salesperson who flies into Detroit the night before taking a client out to lunch and flies home afterward will have spent more than one day in Michigan.<sup>10</sup> Although the client may be impressed with that

also Pomp and McIntyre, “Adrift Without a Rudder — A Response to Seaman Miethke,” *State Tax Notes*, Aug. 12, 1996, p. 487, *Doc 96-22516*, or 96 *STN 157-44*.

<sup>9</sup>MCL 208.1200.

<sup>10</sup>Physical presence exists for one day when physical presence is established for any portion of a day. Revenue Administrative Bulletin 2008-4 (Oct. 21, 2008).

visit, a court may be less so, especially if no business was discussed during that visit.<sup>11</sup>

One of the authors (McIntyre) has suggested a minimalist reading of *Quill*,<sup>12</sup> a position that has found some support from the Wyoming Supreme Court<sup>13</sup> and might support the minimalist reading of *Quill* implicit in Michigan's nexus standard. His article challenges a common reading of *Quill* that physical presence is required for nexus. Instead, the article argues that physical presence is a sufficient condition but not a necessary one:

The [*Quill*] Court . . . established two safe-harbor rules governing the collection obligations of remote sellers, one favoring the states and the other favoring the remote seller . . . The first safe-harbor rule . . . is that the remote seller has nexus . . . if it has a physical presence in the state and that physical presence is not *de minimis*. Under the second safe-harbor rule, drawn from *Bellas Hess*, a remote seller does not have nexus with a state if it does not have a physical presence in the state (other than the *de minimis* amount) and its "only connection with customers in the [taxing] state is by common carrier or the United States mail."<sup>14</sup>

<sup>11</sup>Revenue Administrative Bulletin 2008 (Oct. 21, 2008) provides that in-state business includes, but is not limited to: performing services; selling, renting, or leasing property, whether real, personal, or mixed, tangible or intangible; soliciting sales; making repairs, doing warranty work, or providing maintenance or service to property sold or to be sold; collecting current or delinquent accounts related to sales of tangible personal property through assignment or otherwise; installing or supervising installation at or after shipment or delivery; conducting training, seminars, or similar events for employees, agents, representatives, independent contractors, brokers, or others acting on its behalf or for customers or potential customers; providing customers any kind of technical assistance or service, including, but not limited to, engineering assistance, design service, quality control, product inspections, or similar services; investigating, handling, or otherwise assisting in resolving customer complaints; providing consulting services; or soliciting, negotiating, or entering into franchising, licensing, or similar agreements.

<sup>12</sup>See generally, Michael J. McIntyre, "Taxing Electronic Commerce Fairly and Efficiently," 52 *Tax L. Rev.* 625 (1997).

<sup>13</sup>See *Buehner Block Co., Inc. v. Wyoming*, 139 P.3d 1150 (Wyo. 2006):

The bright-line rule of *National Bellas Hess* and *Quill* does not require physical presence in a state. Rather, the bright-line rule simply holds that, where there is no physical presence in a state, and the only connection between the state and the entity or transaction is by mail or common carrier, there is no "substantial nexus" that will support imposition of a sales or use tax. The requirement of a substantial nexus, rather than the requirement of actual physical presence, necessarily implies that something less than physical presence may suffice.

<sup>14</sup>McIntyre, *supra* note 12, at 637.

The second rule is labeled the "brown truck" rule, after the color of the trucks used by UPS. Presumably, Michigan would be prepared to argue that one day of physical presence is not *de minimis* under the suggested safe harbor rule.

### 3. Nexus From Presence of Employees, Agents, and Independent Contractors

A corporation, which is a legal construct, cannot have physical presence of its own anywhere. Nevertheless, it can be present in a state through property it owns or leases, or through those acting on its behalf. The Michigan statute addresses that latter situation by providing that:

Physical presence means any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity. Physical presence does not include the activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in [Michigan].<sup>15</sup>

Oddly, the Michigan statute does not expressly assert that a business can have nexus through the property it owns or leases in the state. It focuses only on nexus through the presence of representatives. The U.S. Supreme Court has clearly held, however, that the ownership or leasing of property provides substantial nexus.<sup>16</sup> Perhaps the drafters simply assumed that holding property so obviously constituted a nexus-creating "activity conducted by the taxpayer" that no reference in the statute was needed. Or the drafters may have nodded, or perhaps, less likely, they decided for unknown reasons not to assert nexus based on a taxpayer's property holdings in Michigan. In any event, the tax administration has made it clear that owning, renting, leasing, maintaining, or using tangible or real property permanently or temporarily located in Michigan is encompassed by the statute.<sup>17</sup>

The nexus section of the Michigan statute recognizes that corporations hire many different kinds of persons who act as independent contractors, representatives, or agents, such as lawyers, architects, advertising brokers, accountants, bankers, purchasing agents, actuaries, freight forwarders, engineers, insurance agents, pension administrators, mortgage brokers, and the like. Corporations also use third parties to make sales into a state. Only those persons acting for a taxpayer in a "representative

<sup>15</sup>MCL 208.1200

<sup>16</sup>See generally, *Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977); *Quill*, 504 U.S. 298.

<sup>17</sup>Revenue Administrative Bulletin 2008-4 (Oct. 21, 2008).

capacity” create nexus for the taxpayer under Michigan’s physical presence test.

An initial question in interpreting the statute is whether the requirement of “acting in a representative capacity” modifies only independent contractors or also modifies employees and agents. The argument for the requirement of not modifying employees is that those persons are typically viewed as constituting physical presence for commerce clause purposes regardless of the nature of their non-de minimis activities. Many employees who commonly would be viewed as creating nexus would not be described as acting in a representative capacity. A taxpayer’s secretary present in the state, for example, would not be considered as “representing” the taxpayer, yet the secretary would more than likely constitute a physical presence in the state. Assuming that the Legislature intended to adopt a physical presence test as broad as is permitted under the Court’s commerce clause jurisprudence and that it did not intend to upset the common understanding that employees create nexus regardless of their activities, two interpretations of the statute are possible. One is that employees should always be viewed as acting in a representative capacity, even if that reading of the literal language of the statute is somewhat strained.<sup>18</sup> The other interpretation is that the “acting in a representative capacity” requirement applies only to independent contractors.

**Oddly, the Michigan statute does not expressly assert that a business can have nexus through the property it owns or leases in the state.**

The difficulty with the latter interpretation is that it would leave “agents” free of the “acting in a representative capacity” requirement without any strong rationale for treating them differently from independent contractors. Unlike employees, agents are not viewed as automatically constituting physical presence regardless of the nature of their activities. In that respect, they are more similar to independent contractors. In short, the statute presents a dilemma. Employees should be treated differently from agents and independent contractors, and the latter two categories should be subject to the same

<sup>18</sup>Despite *Quill*’s emphasis on a bright line test, there are a small number of cases holding that an employer does not constitute commerce clause nexus for the sales and use tax based on what appears to be a quantitative and qualitative analysis. See Pomp and Oldman, *supra* note 8, at 9-69. These cases, however, did not turn on whether the employees were “representating” their employers.

rules. The statute, unfortunately, does not easily allow for that construction.

#### 4. Establishing and Maintaining a Market

To create nexus for its principal, the activities of a service provider must be “significantly associated with the taxpayer’s ability to establish and maintain a market in” Michigan.<sup>19</sup> That language has its origins in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*,<sup>20</sup> a case involving the Washington B&O tax. One issue in that case was whether Tyler Pipe had sufficient nexus with Washington to be subject to the gross receipts tax.

Tyler maintain[ed] no office, own[ed] no property, and ha[d] no employees residing in the State of Washington. Its solicitation of business in Washington [wa]s directed by executives who maintain[ed] their offices out-of-state and by an independent contractor located in Seattle.

The U.S. Supreme Court held that nexus existed. It endorsed the statement of the Washington Supreme Court that “the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are *significantly associated with the taxpayer’s ability to establish and maintain a market* in this state for sales.” The Court also agreed with the state court that the existence of nexus “could not be defeated by the argument that the taxpayer’s representative was properly characterized as an independent contractor instead of as an agent.” The Court characterized the independent contractor as a representative, suggesting that independent contractors, representatives, and agents were viewed the same when it came to nexus.

The Court has never elaborated on the nature of a representative’s activities that will be viewed as establishing or maintaining a market. Litigation can be expected now that Michigan has statutorily embodied all of those terms without defining them. Some types of activities, such as holding out the taxpayer’s products for sale to customers, would clearly constitute market-enhancing, nexus-creating activities. But other cases are far less clear. A lawyer who draws up the critical sales contract that a business firm uses in Michigan, or who sues the firm’s competitor to keep it out of the Michigan

<sup>19</sup>The statute does not explicitly exclude employees from that category. Employees are certainly “service providers,” but certainly not all employees will be involved in establishing and maintaining a market. Literally interpreted, the statute would prevent many employees from creating nexus. That interpretation suggests that the “establishing and maintaining a market” requirement applies only to nonemployees.

<sup>20</sup>483 U.S. 232 (1987).

market, could be described as satisfying the statutory nexus-creating requirements of representing the taxpayer and being involved in “establishing or maintaining a market”; yet a finding of nexus would contradict common understanding of the tax effects of hiring a lawyer. The Michigan Department of Treasury has provided some guidance by setting forth a list of activities that if performed only for fewer than 10 days will not constitute physical presence.<sup>21</sup>

The activities of independent contractors, agents, or representatives can be arrayed on a continuum. At one end are sales activities and market-related activities, such as soliciting sales on behalf of the taxpayer.<sup>22</sup> At the other end are activities having nothing to do with the solicitation or generation of sales, such as the activities of an accountant or a stockbroker. The issue is where on the continuum to draw the nexus-creating line. To be sure, corporations are in the business of making a profit from selling goods or providing services, so that on a general level everyone hired, whether an employee or a third party, ultimately contributes to the corporation’s ultimate economic well-being. That logic, however, would mean that a corporation would have nexus in any state in which any independent contractor, agent, or representative performed services on its behalf — a position that no state has ever taken and that no commentator has ever endorsed.

Instead, the line that many states seem to have drawn is that the purchase of services from local firms, such as the use of lawyers, bankers, or accountants, will not be viewed as creating nexus. For example, an independent contractor, agent, or representative selling goods or services in Michigan on behalf of an out-of-state corporation would create nexus. But nexus would not result from the use of a Michigan law firm that drew up the sales contract, a Michigan advertising firm that created the commercials that advertised the product, a Michigan bank

that financed the purchase of inventory, or a Michigan accounting firm that calculated the profit on the sale.

The line we are describing is prescriptive and not normative and is consistent with pragmatic considerations of economic development. No tax commissioner, unless compelled by the governing statute, is likely to adopt a position on nexus that offers out-of-state businesses an incentive to avoid using in-state service providers. A tax commissioner who broadly interpreted “establishing or maintaining a market” to cover the Michigan service providers described above would likely be overruled rather quickly by the Michigan Legislature.

Two situations illustrate how legislatures act to protect local industries from what would otherwise be viewed as nexus-creating events. In the first situation, an out-of-state corporation hires an in-state firm to print a catalog. The corporation may have its employees come to the printing firm’s premises when page proofs are being run in order to make last-minute adjustments. Also, the corporation might supply the printer with paper it purchased at wholesale to reduce costs. Having people and property in the state would normally create nexus. To protect the local printing industry, many states have passed legislation providing that nexus is not created when a taxpayer having no other nexus-creating contacts with a state uses an in-state printer, stores property at the printer’s plant for use in printing, or visits the printer’s plant.

In the second situation, an out-of-state corporation may appear at a Michigan trade show. Many states have convention centers that are a logical venue for trade shows. But trade shows will normally involve nexus-creating activities, discouraging out-of-state vendors that otherwise do not have nexus from exhibiting if they then become subject to tax in the state on their subsequent sales when they return home. Accordingly, some states have adopted favorable rules specifying that limited use of a convention center will not constitute nexus.

Of course, Michigan has not yet adopted legislation of the type discussed above. Its statutory nexus standard seems to extend about as far as *Quill* permits. The experience of other states suggests, nevertheless, that the Michigan Department of Treasury is likely to interpret the term “establishing or maintaining a market” in a limited, rather than broad, manner when the latter reading of the nexus standard would put Michigan service firms at a significant competitive disadvantage.

## 5. Nexus From Economic Presence

The above discussion dealt with physical presence. The statute also defines substantial nexus in

<sup>21</sup>The following activities do not constitute nexus if they are performed for less than 10 days and are a taxpayer’s only activities in Michigan: meeting with in-state suppliers of goods or services; meeting with government representatives in their official capacity; attending occasional meetings; holding recruiting or hiring events; advertising in the state through various media; renting to or from an in-state entity customer list; and attending or participating at a trade show at which no sales are solicited or made. Revenue Administrative Bulletin 2008-4 (Oct. 21, 2008).

<sup>22</sup>See generally, *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) (holding that a nexus exists when persons variously described as brokers, wholesalers, jobbers, or independent contractors solicit sales on a commission basis for out-of-state taxpayer).



terms of economic presence: “the active solicitation of sales in Michigan and Michigan gross receipts of at least \$350,000.”<sup>23</sup> Is that nexus test consistent with *Quill*? That case dealt with a traditional sales and use tax. If the Michigan gross receipts tax is viewed as a sales and use tax, and if physical presence is viewed as a necessary condition for nexus, the economic presence standard would be unconstitutional.

As discussed above, the Michigan MGRT is not the type of traditional retail sales tax that was before the Court in either *Bellas Hess* or *Quill*. True, the tax may be intended to fall on consumption, similar to a sales and use tax. But the similarity ends there. Moreover, the *Quill* Court, at least to some extent, was protecting reliance interests based on *Bellas Hess*. Taxpayers under the Michigan MGRT have no claim to such protection. If the MGRT is not viewed as a traditional sales and use tax, as seems likely, the constitutionality of its economic presence test turns on whether the physical presence test must be satisfied for taxes other than sales and use taxes.

The application of *Quill* and its physical presence test to taxes other than sales and use taxes has been litigated heavily throughout the country,<sup>24</sup> usually in the context of the required nexus standard for corporate income taxes. Those who argue in support of an economic presence test for income taxes contend that *Quill* has limited application outside of sales and use taxes. They have had some recent successes in the courts. For example, the West Virginia Supreme Court recently rejected physical presence as the appropriate nexus standard in an income tax and endorsed an economic presence standard.<sup>25</sup> The taxpayer in that case, MBNA America Bank, issued credit cards and earned money from their use. The court held that MBNA did not satisfy the physical presence standard because it had no people or property in the state but nonetheless had substantial nexus under the economic presence standard because of the frequency and systematic nature of the company’s contacts with West Virginia in earning money from credit card transactions conducted in the state.<sup>26</sup>

<sup>23</sup>Mich. Comp. Laws Ann. section 208.1200(1) (West Supp. 2007).

<sup>24</sup>See, e.g., *Lanco v. Dir. Div. of Taxation*, 879 A.2d 1234 (N.J. 2005); *Tax Comm’r v. MBNA Am. Bank*, 640 S.E.2d 226 (W. Va. 2006), and the cases cited therein. For the New Jersey appellate division decision in *Lanco*, see *Doc 2005-17765* or *2005 STT 166-13*; for the West Virginia Supreme Court of Appeals decision in *MBNA*, see *Doc 2006-23668* or *2006 STT 228-18*.

<sup>25</sup>See generally *Tax Comm’r v. MBNA Am. Bank*, 640 S.E.2d 226 (W. Va. 2006).

<sup>26</sup>See *MBNA America Bank*, 640 S.E.2d at 235.

Proponents of an economic presence standard for taxes other than sales and use taxes usually emphasize the nature of the modern U.S. economy, which allows remote vendors to benefit substantially from a state’s marketplace without having a physical presence in the state. They also stress two passages in *Quill*: “although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use tax”; and “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.” They also emphasize the acknowledgment of the *Quill* Court “that contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today,” and the lack of a *Bellas Hess*-type precedent for taxes other than sales and use taxes.

Those who argue that physical presence is the appropriate nexus standard for all taxes, not just sales and use taxes, note that no commerce clause nexus case has ever involved a taxpayer that did not have a physical presence. Consequently, they interpret the passages above from *Quill* as merely meaning that the Court has never had to articulate a physical presence standard in the case of nonsales tax cases. Defenders of a general physical presence standard assert that the benefits of a bright-line test cited by *Quill* — the reduction of litigation, the encouragement of settled expectations, the fostering of investment — would be undercut by the adoption of a new economic presence standard with which the states have had little experience.

Supporters of an economic presence test argue that this test need not create uncertainty as long as it is clearly stated, as it is under the Michigan statute. If properly formulated, the test arguably can be just as clear, or clearer, than the allegedly bright-line test of *Quill*. Opponents reply that two states can have conflicting bright-line tests; for example, in a case like *MBNA*, one state might locate income to the state where the credit card is used and another might locate it where the cardholder is billed. The critics suggest that uniformity is best achieved by Congress imposing a uniform standard.

Another argument that might be advanced for the economic presence test is that this test, properly formulated, would give greater weight to substance than to form and might reduce opportunities for abusive tax avoidance. Of course, what is characterized as tax avoidance from one perspective may be characterized as legitimate tax minimization from a competing perspective. A commonly made argument

for the test, perhaps of some appeal to local businesses, is that it may help protect them from the unfair competition that could result when taxpayers located outside the state engage in substantial business activities in the state without bearing any of the costs of government.<sup>27</sup> Opponents respond by asserting that taxpayers lacking physical presence do not impose significant costs on a government and benefit only incidentally from services provided by a state to its citizens. No one can dispute, nevertheless, that taxpayers having economic presence benefit from the exploitation of the in-state market, although commentators may not agree on the significance of that point.

**Certainly, the threat of litigation should not deter a state from adopting a rule that it considers to be both constitutional and significant.**

Whatever the merits of its position, Michigan can expect litigation over its use of an economic presence test. We will not predict how the U.S. Supreme Court would decide if that issue were to reach it. In preparing to meet the almost inevitable challenges to the constitutionality of its economic presence test, Michigan can take some comfort from the fact that the Court has denied certiorari in many cases asking for a resolution of whether physical presence or economic presence is the nexus standard for taxes other than sales and use taxes.<sup>28</sup> Certainly, the threat of litigation should not deter a state from adopting a rule that it considers to be both constitutional and significant. Otherwise, all contentious legal issues would be decided by default in favor of the taxpayer.

<sup>27</sup>Charles E. McLure Jr., "Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Law," 52 *Tax L. Rev.* 269, 296 (1997):

Extension of existing nexus rules [physical presence test] to electronic commerce would place local merchants at a competitive disadvantage, especially relative to large out-of-state competitors. Thus, it is essential that adoption of an economic nexus standard be accompanied by greater uniformity of state sales taxes and de minimis rules that would exempt out-of-state vendors making small amounts of sales into a state from the duty to collect use taxes.

<sup>28</sup>*See, e.g., Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), cert. denied 510 U.S. 992 (1993); *MBNA Am. Bank*, 640 S.E.2d 226, cert. denied; *FIA Card Servs., N.A. v. Tax Comm'r*, 127 S. Ct. 2997 (2007). A decision to deny certiorari is, of course, not a decision on the merits.

#### IV. Apportionment of the Tax Base

The MBT statute defines the tax base of the MGRT as worldwide gross receipts reduced by worldwide purchases from other firms. Both terms are defined broadly but not comprehensively. This tax base is then apportioned between Michigan and the rest of the world using a sales-only apportionment formula — that is, Michigan sales divided by worldwide sales.

The Michigan apportionment formula uses unadjusted gross proceeds from sales, rather than sales reduced by purchases from other firms, in the numerator and denominator of the apportionment fraction. The effect of that rule is that deductions for purchases from other firms are allocated pro rata to sales (gross receipts), even though those purchases may not relate directly to any particular sale. Tying a specific purchase to a particular gross receipts, however, would be an extremely complex undertaking in many cases — an undertaking Michigan wisely bypassed.

##### 1. Constitutional Considerations

The U.S. Supreme Court has long held that corporate income taxes must be fairly apportioned<sup>29</sup> and that almost any reasonable apportionment formula will withstand constitutional challenge under the dormant commerce clause.<sup>30</sup> The issue is less clear for gross receipts taxes. The Court has held on some occasions that apportionment of particular gross receipts taxes is required.<sup>31</sup> In some early cases, it also sustained an unapportioned gross receipts tax case on grounds that seem to elevate form over substance.<sup>32</sup>

The Michigan MGRT is apportioned using a sales-only apportionment formula. "Sales" in that context includes gross receipts not only from sales transactions but also from many other transactions as well. That broad definition of sales is consistent with the uniform practice of states in apportioning income under their corporate income taxes.<sup>33</sup>

<sup>29</sup>*See Complete Auto Transit*, 430 U.S. 274.

<sup>30</sup>*See Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

<sup>31</sup>*See Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948).

<sup>32</sup>*See, e.g., General Motors Corp. v. Washington*, 377 U.S. 436 (1964), overruled in part by *Tyler Pipe*, 483 U.S. 23; *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975).

<sup>33</sup>*See, e.g., Uniform Division of Income for Tax Purposes Act section 1(g)* (1957), available at [http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920\\_69/udiftp57.htm](http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69/udiftp57.htm) (last visited December 12, 2008) ("sales" means all gross receipts of the taxpayer not allocated under sections 4 through 8 of this Act").

Michigan's use of an apportionment formula for its MGRT is unquestionably a constitutional requirement, despite the lack of clarity in the Court's position generally on the apportionment of gross receipts taxes. The reason is that the unapportioned tax base explicitly includes the proceeds of sales and other transactions having no origin or destination in Michigan, such as a good produced and sold outside of Michigan. Under the U.S. Constitution, "some definite link, some minimum connection"<sup>34</sup> must exist between Michigan and the activities generating the modified gross receipts that the state seeks to tax. A further condition is that a rational relationship must exist between the tax base and the activities conducted within Michigan. The state can tax only those modified gross receipts that are fairly attributable to activities in Michigan. Those constitutional requirements would be violated without some form of apportionment. Moreover, without apportionment, the tax would be internally inconsistent — that is, it would necessarily produce double taxation if adopted by the other states.<sup>35</sup>

The gross receipts taxes that have been upheld by the Court generally have been ones that it could formally describe as imposing burdens only on activities conducted within the taxing jurisdiction. For example, Washington's gross receipts tax<sup>36</sup> on wholesaling within the state was upheld because the wholesaling activity took place there, even though the goods were produced elsewhere.<sup>37</sup> Although the Court was content with the fact that the wholesaling took place in Washington, the economic reality was that the tax was imposed on gross receipts that were attributable in part to the manufacturing that occurred elsewhere; hence, Washington was in effect taxing values generated outside the state.<sup>38</sup> We have criticized the Court's upholding of Washington's gross receipts tax on the wholesaling of goods in the state that were manufactured elsewhere as reflecting the type of formalistic reasoning that the Court claims to have forsworn after the transformation of its dormant commerce clause jurisprudence in the *Complete Auto* era.<sup>39</sup> We have also argued that this line of reasoning should not survive the Court's

decision in *Oklahoma Tax Commissioner v. Jefferson Lines*.<sup>40</sup> Several state courts have subsequently agreed.<sup>41</sup>

We suggest that the Michigan MGRT is best understood as a modified sales-subtraction VAT. So viewed, the tax is directed at taxing consumption within Michigan. To achieve that result, apportionment under a sales-only formula is appropriate. Otherwise, the MGRT would tax consumption in every state of taxable goods and services sold by any taxpayer having nexus with Michigan. Such a tax would be nonsensical from a policy perspective. It also would be unquestionably unconstitutional.

The MGRT, as well as the business income tax, requires some taxpayers engaged in a unitary business to compute their tax on the basis of a combined report. The constitutionality of combined reporting in the context of a corporate income tax is beyond doubt.<sup>42</sup> We see no reason why the extension of the rule to the MGRT should present any new constitutional issues. The basic constitutional issue is nexus — once that is established, the particular tax imposed would seem to be irrelevant.<sup>43</sup>

One constitutional issue that is relevant for both the Michigan business income tax and the MGRT arises from Michigan's adoption of its water's-edge rule, discussed below. In general terms, Michigan excludes from its definition of a unitary business group all foreign persons and a few domestic persons engaged primarily in foreign business activities. A constitutional issue arises if the water's-edge system gives a more favorable result for U.S. persons than for foreign persons. In that event, an argument might be made that the rule violates the foreign

<sup>40</sup>514 U.S. 175 (1995). See Hellerstein, McIntyre, and Pomp, *supra* note 40, at 97-102. In *Jefferson Lines*, the Court characterized a gross receipts tax as "simply a variety of a tax on income, which was required to be apportioned to reflect the location of the various interstate activities by which it was earned." *Jefferson Lines*, 514 U.S. at 190. Income taxes on cross-border activities must be apportioned.

<sup>41</sup>See, e.g., *Northwood Constr. v. Twp. of Upper Mooreland*, 856 A.2d 789 (Pa. 2004), *cert. denied*, 125 S. Ct. 1736 (2005) (municipal business privilege tax); *Ford Motor Co. v. City of Hazelwood*, No. 02CC-00296 (Mo. 21st Cir. Ct. Aug. 26, 2003) (city gross receipts tax); *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108 (Pa. 2003) (city business privilege tax); *M & Assoc., Inc. v. City of Irondale*, 723 So.2d 592 (Ala. 1998) (city license tax); *City of Winchester v. American Woodmark Corp.*, 471 S.E.2d 495 (Va. 1996) (city business professional and occupational license tax). *But see Ford Motor Co. v. City of Seattle*, 156 P.3d 185 (2007), *cert. denied*, 128 S. Ct. 1224 (2008).

<sup>42</sup>See generally, *Container*, 463 U.S. at 159, and *Barclays Bank v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

<sup>43</sup>See generally, McIntyre, *supra* note 12 (arguing that a corporation should not be able to avoid nexus for sales and use tax purposes by isolating nexus-creating assets and activities in an affiliated company that is a member of its unitary group).

<sup>34</sup>*Miller Bros. v. Maryland*, 347 U.S. 340, 344-345 (1954).

<sup>35</sup>See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165-166 (1983).

<sup>36</sup>Wash. Rev. Code Ann. sections 82.04.010-82.04.900 (West 2006).

<sup>37</sup>See generally, *Tyler Pipe v. Washington*, 483 U.S. 232 (1987).

<sup>38</sup>See *id.* at 251 ("the activity of wholesaling — whether by an in-state or out-of-state manufacturer — must be viewed as a separate activity conducted wholly within Washington that no other State has jurisdiction to tax").

<sup>39</sup>See Walter Hellerstein, Michael J. McIntyre, and Richard D. Pomp, "Commerce Clause Restraints on State Taxation after *Jefferson Lines*," 51 *Tax Law Rev.* 47, 95-97 (1995).

commerce clause. California, like other states, addresses the issue by making its water's-edge regime elective.<sup>44</sup> Those not making the election are required to include all participants in the unitary business, foreign and domestic, in the unitary business group.<sup>45</sup>

## 2. Defining a Michigan Sale

Every state having a corporate income tax includes sales as one of the apportionment factors.<sup>46</sup> As a result, all of those states have adopted rules for determining when a sale occurs within their jurisdiction. The rules typically differ, however, depending on the nature of the goods or services sold.<sup>47</sup> The Multistate Tax Commission has developed regulations providing guidance on the issue.<sup>48</sup>

The MBT provides rules for determining the location of sales that do double duty — they determine the location of sales both for the business income tax and for the MGRT. The rules are reasonably detailed, primarily to take account of the variety of different types of businesses subject to the two taxes. The rules dealing with the sale of tangible personal property and the sale of services are addressed below.

### *a. Locating a Sale of Tangible Personal Property*

The Uniform Division of Income for Tax Purposes Act provides that a sale of tangible personal property is assigned to a particular state if “the property is delivered or shipped to a purchaser within this state.”<sup>49</sup> The MTC regulations interpret UDITPA to mean that “property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.”<sup>50</sup> The MGRT starts off with the UDITPA rule, but adds a significant wrinkle. It provides:

Sales of tangible personal property are in this state if the property is shipped or delivered, or, in the case of electricity and gas, the contract requires the property to be shipped or delivered, to any purchaser within this state *based on the ultimate destination at the point that the property comes to rest* regardless of the free on board point or other conditions of the sales.<sup>51</sup>

The objective of the italicized language above is unclear. Under one reading, the point is simply to exclude from Michigan sales those goods that are delivered to a Michigan purchaser merely for transshipment elsewhere. The classic example is a so-called dock sale. That category describes a customer that takes delivery at the vendor's shipping dock using its own trucks or alternatively, a common carrier. If the vendor can substantiate that the goods are taken out of state, the sale will not be viewed as occurring in state.

Dock sales involve outbound situations. The parallel situation involving inbound sales would be if a firm in New York trucks goods to a purchaser's warehouse in Michigan, and the goods are then transferred by the purchaser to another truck and taken to Illinois. In that case, the transit in Michigan should not attract a tax provided the New York firm can document the transshipment. As applied to these examples, the rule makes good sense. It may also further the attractiveness of Michigan as a place to store temporarily goods from out of state that are destined for shipment elsewhere.

A second reading, consistent with the first, is that sales of goods shipped and delivered outside of Michigan will be treated as Michigan sales if the ultimate destination is Michigan. This rule can be understood as an antiavoidance rule. For example, if a New York firm ships goods to a Michigan customer only as far as Toledo, Ohio, and the customer picks up the goods there for transport to Michigan, the sale should be characterized as a Michigan sale, assuming the vendor documents that the goods actually were transported to Michigan.

Under a third reading, sales of goods would constitute non-Michigan sales if the goods are delivered to a purchaser in Michigan without any transshipment plan (which distinguishes this case from the dock sales discussed above), and those goods are later resold to purchasers who take the goods outside the state. The MTC regulation explicitly rejects that position.<sup>52</sup> It provides that goods delivered to a

<sup>44</sup>Calif. Revenue and Taxation Code section 25110(a) (West 2008).

<sup>45</sup>For discussion of the constitutional problems arising from excluding foreign corporations from the combined report, see Michael J. McIntyre, Paull Mines, and Richard D. Pomp, “Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana,” 61 *La. L. Rev.* 699, 734 (2001).

<sup>46</sup>*See, e.g.*, Cal. Rev. & Tax Code section 25128(a) (West 2004).

<sup>47</sup>*See, e.g.*, UDITPA sections 16-17 (1957), available at [http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920\\_69/udiftp57.htm](http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69/udiftp57.htm) (last visited December 12, 2008).

<sup>48</sup>Allocation and Apportionment Regulations, IV.16-18, Multistate Tax Commission (2007), available at [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/AllocationandApportionment\\_Reg.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocationandApportionment_Reg.pdf) (last visited December 12, 2008).

<sup>49</sup>*See* UDITPA section 16, *supra* note 33.

<sup>50</sup>MTC Reg. IV.16 (a)(3) (1973), *supra* note 48.

<sup>51</sup>Mich. Comp. Laws Ann. section 208.1305(1)(a) (West Supp. 2007) (emphasis added).

<sup>52</sup>The MTC sets forth an example providing that a “taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of the taxpayer's products

(Footnote continued on next page.)

state are treated as in-state sales if the shipment terminates in the state even if the goods are ultimately delivered to a purchaser outside the state.

The first two readings of the statute require the vendor to know the place where the purchaser is ultimately shipping the goods. If the purchaser is cooperative, the place of ultimate shipment is knowable. The third reading, if actually intended by the Legislature, presents more troubling problems. Treating goods ending up outside the state as non-Michigan sales would be correct in principle if the goal of the MGRT were to exempt goods consumed out of state. But doing so is not so easy.

Consider, for example, a Michigan grocery store selling food at retail to its customers. Some customers may have driven from Ohio, purchased groceries, and taken them back to Ohio. Is the grocer expected to know that? Is the grocer expected to ask customers where they plan to consume the goods? The same problem exists for retailers operating in a shopping mall located within driving distance of the Ohio, Ontario, Indiana, or Wisconsin borders. Not even the Michigan retail sales tax requires retailers to ascertain the ultimate destination of the goods they sell over the counter.

A similar problem arises from sales to distributors or wholesalers and sales of goods to producers that incorporate those goods into their products. Even if the purchaser were willing to share proprietary information about its customers with the Michigan seller, the purchaser may not know in the year of the sale where the goods will ultimately come to rest. The goods may not have been resold at the time that the seller has to file its MGRT return. Or the goods may have been resold to yet another distributor or wholesaler. If the goods sold were incorporated into new products, it would be unreasonable, if not impossible, for the original seller to learn from its purchaser/producer the destination of those new products.

An additional complication arises if the purchaser has resold only some of the goods previously purchased from the Michigan seller. In that case, some accounting convention, such as last in, first out or first in, first out, would be needed to determine which of the goods were sold and which still remain in inventory. As this brief discussion suggests, those administrative complications argue against the third interpretation of the statute.

Of course, the problem of administering an exception for goods ultimately shipped outside the state is not so difficult for sales of some goods, such as automobiles, boats, or planes, which have to be

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shipped to the purchaser's warehouse in this state constitute property delivered or shipped to a purchaser within this state." MTC Reg. IV.16.(a)(3), *supra* note 48.

registered. If the point is to have a special rule for those sales, however, the Michigan Legislature should have said so.

### **b. Locating a Sale of Services**

UDITPA provides that:

sales, other than sales of tangible personal property, are in this state if: (a) the income-producing activity is performed in this state; or (b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.<sup>53</sup>

That so-called cost of performance rule may be acceptable for an income tax, which is intended to tax income attributable to in-state activities, but was rejected for use in the Michigan MGRT, which may be seen as a tax intended to reach consumption within the state.

Instead of cost of performance, the MGRT provides the following rule for determining the location of services:

Except as otherwise provided in this section, all receipts from the performance of services are included in the numerator of the apportionment factor *if the recipient of the services receives all of the benefit of the services in this state*. If the recipient of the services receives some of the benefit of the services in this state, the receipts are included in the numerator of the apportionment factor in proportion to the extent that the recipient receives benefit of the services in this state.<sup>54</sup>

That rule may be correct in principle, on the assumption that the purpose of the MGRT is to tax consumption enjoyed within Michigan. Unfortunately, it is totally unworkable. An individual goes into a barbershop for a haircut just before going on a long trip outside the state. Is the barber expected to ascertain whether the customer will receive all of the benefits of the hair-cutting service within Michigan? Barbers typically are chatty people, but are they now required to be chatty to comply with the tax laws? What about automobile repair services? Is the customer going to be asked for a breakdown of in-state and out-of-state travel plans? Is the auto mechanic responsible for checking if those plans come to fruition?

In administering its gross receipts tax (CAT), the Ohio Department of Taxation has provided guidance

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<sup>53</sup>UDITPA section 17, *supra* note 33. The MTC regulations interpreting section 17 are found in MTC Reg. IV.17, but are irrelevant to the discussion in the text. See MTC Reg. IV.17, *supra* note 48.

<sup>54</sup>Mich. Comp. Laws Ann. section 208.1305(2)(a) (West Supp. 2007) (emphasis added).

on the location of gross receipts from services.<sup>55</sup> To say those voluminous rules are “detailed” would be a major understatement. In general, the CAT regulations assign services to Ohio if the services are delivered at retail in Ohio. For example, veterinarian services performed in Ohio are located exclusively in Ohio, even if the pet owner is a nonresident. Towing services are located in Ohio if the services originate in Ohio, regardless of the destination of the vehicle being towed. The same “delivery” rule applies to repair services if the goods to be repaired are left off and picked up at a repair shop located in Ohio, even if they are immediately removed from the state. Services obtained at a barber shop, beauty salon, or spa are located exclusively in Ohio if the services are performed at an Ohio location, even if the customer lives outside Ohio.

**The rule for determining the location of services may be correct in principle. Unfortunately, it is totally unworkable.**

The situs rules found in Ohio’s CAT regulations may provide the Michigan tax authorities with a useful starting point in specifying the location of gross receipts from the sale of services. The Ohio rules do not pretend to ascertain where the benefits of services are ultimately obtained. They are practical rules that generally locate services in Ohio if that state is the jurisdiction best able to impose the tax. Michigan is going to be compelled to make similar compromises with consumption tax principles to successfully administer the MGRT.

Locating sales of intermediate services presents new difficulties. The apparent objective of the MGRT statute is to locate services in the state where the consumption benefits of the services are enjoyed. Intermediate goods, almost by definition, are not consumed anywhere. Instead, they are incorporated into some final good or service, and it is that final good or service that is consumed. The service provider cannot be expected to ask the purchaser to keep track of those services until the ultimate consumer enjoys them. In many ways, the problem is similar to determining the ultimate destination of tangible personal property, discussed above.

Michigan will have to develop practical rules that establish the location of intermediate services. The

touchstone for those rules cannot be the place of consumption because intermediate services are not consumed by the purchaser. Ohio, in its CAT regulations, seems to have moved toward a place of use test in the majority of cases involving intermediate services; however, it also uses other tests, including place of performance. Michigan probably will have to use multiple tests, each designed to simplify administration and limit opportunities for tax avoidance and evasion. A place of use test, nevertheless, is probably a good place to start in developing workable rules.

### V. Unitary Business Concept in the Context of an Adjusted Gross Receipts Tax

In accordance with best tax practices, Michigan has adopted a combined reporting system both for its business income tax and for the MGRT. Under combined reporting, related taxpayers engaging in a unitary business are treated in some respects as if they were a single taxpayer, with transactions within the unitary business group eliminated in determining net income subject to apportionment. The income of the unitary business group is then apportioned by formula to each state in which members of the group are conducting business.<sup>56</sup> In recent years Massachusetts (2008), New York (2007), Texas (2006) Vermont (2004), West Virginia (2007), and Wisconsin (2009) have adopted a combined reporting rule, joining California and 15 other states that have used the rule successfully for decades.<sup>57</sup> Thus, Michigan is joining an emerging trend among the states toward combined reporting. Michigan also is breaking new ground because the Michigan business income tax and the MGRT apply to all business firms, not just corporations, and its combined reporting rule extends to qualified business firms, however organized, that are engaged in a unitary business.

Tax specialists have promoted combined reporting for many years as an effective method for fairly apportioning the tax base of a corporate income tax and for combating some forms of aggressive tax avoidance.<sup>58</sup> We will not reprise that literature here

<sup>56</sup>See, e.g., Cal. Revenue and Taxation Code section 25128(a) (West 2004); Mich. Comp. Laws Ann. sections 208.1301(1), (3) (West Supp. 2007).

<sup>57</sup>See Michael Mazerov, “State Corporate Tax Shelters and the Need for ‘Combined Reporting,’” Center on Budget and Policy Priorities (Oct. 26, 2007), available at <http://www.cbpp.org/10-26-07sfpp.htm> (last visited December 13, 2008).

<sup>58</sup>For our joint contribution to that literature, see McIntyre, Mines, and Pomp, *supra* note 46. See also Michael J. McIntyre, “The Use of Combined Reporting by Nation States,” in *The Taxation of Business Profits Under Tax Treaties* (Arnold, Sasseville, and Zolt, eds. 2003), revised and reprinted in *35 Tax Notes Int’l* 917-48 (Sept. 6, 2004).

<sup>55</sup>See Ohio Admin. Code section 5703-29-17 (West 2008) (discussing the siting of some services for purposes of the CAT). The Ohio tax is fundamentally different from the MGRT. Ohio taxes only services that are sited to that state. It does not use an apportionment formula to make that determination. Instead, as discussed in the regulation, it has an elaborate set of rules for determining the situs of services.

or discuss the various arguments, pro and con, for implementing a combined reporting rule for the Michigan business income tax. We limit ourselves to briefly describing Michigan's rules for applying combined reporting to the MGRT and discussing some special issues.

A combined reporting regime applies to all relevant firms engaged in a unitary business in the state, regardless of whether a particular member of what Michigan refers to as the "unitary business group"<sup>59</sup> has substantial nexus with the state as a result of its own activities in the state.<sup>60</sup> Michigan has adopted the majority rule and has rejected what is known as "nexus combination." Under the nexus combination rule, only those members of the unitary business group that have independent nexus with the state are included in the combined report. Under the Michigan rule, which we strongly endorse and which the U.S. Supreme Court has approved, a combined report is required to be filed if any member of the unitary group meets the substantial nexus standard.

The MGRT provides that, in computing their tax liability, members of a unitary business group are required to eliminate all intragroup transactions. That rule determines both the base of the tax and the numerator and the denominator of the sales-only apportionment formula. Eliminating transactions between related persons prevents members of a unitary business group from using inappropriate transfer prices to inflate their deduction for purchases from other firms or from minimizing the amount of their sales.

Because almost all sales between related persons are sales of intermediate goods and services, removing those sales eliminates the need to determine their location. Given the problems discussed above in determining the location of intermediate sales, eliminating them from the tax base and from the apportionment formula should reduce administra-

tive problems both for tax administrators and for taxpayers that are members of a unitary business group.

Membership in a unitary business group is limited to U.S. persons. Foreigners need not apply. The exclusion of some or all foreign persons from the unitary group is popularly referred to as a water's-edge rule. Water's-edge rules vary from state to state. Some states do as Michigan has done and simply provide that only U.S. persons (or only persons filing federal consolidated returns, or that can file those returns) can be members of a unitary business group. Other states, notably California, would include some "tax haven" foreign corporations in the elective water's-edge group to prevent tax avoidance.<sup>61</sup> Limiting membership in the unitary business group only to U.S. persons may present constitutional difficulties. That rule also offers some avenues for tax avoidance. For example, a rule limiting the unitary business group to U.S. entities would allow taxpayers to avoid Michigan tax by deflecting gross receipts to a foreign holding company or a foreign company with minimal business activities.<sup>62</sup> At a minimum, the tax authorities should be given the authority to include foreign entities in a unitary business group if inclusion is necessary to prevent abusive tax avoidance. The tax authorities also should have explicit authority to treat any entity as a domestic entity if it is so treated for federal tax purposes.

The Michigan water's-edge rule also excludes some U.S. persons identified as foreign operating entities. A U.S. person qualifies for this classification if it has "substantial operations outside the United States, the District of Columbia, the Commonwealth of Puerto Rico, [or] any territory or possession of the United States," and "at least 80% of its income is active foreign business income."<sup>63</sup> That rule can present taxpayers with opportunities for tax avoidance. It should be modified to allow the tax

<sup>59</sup>The MBT defines a unitary business as:

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

<sup>60</sup>See Mich. Comp. Laws Ann. section 208.1511 (West Supp. 2007). For a general discussion, see McIntyre, Mines, and Pomp, *supra* note 45.

<sup>61</sup>For a detailed discussion of the California rules and suggestions on how best to design a water's-edge system, see McIntyre, Mines, and Pomp, *supra* note 46, at 732-38. One improvement on the Michigan rule would be to include foreign entities in the combined group if they have over 20 percent of their business activity in the United States. See, e.g., 35 Ill. Comp. Stat. Ann. 5/1501(a)(27) (West 2008) (defining unitary business group to exclude "those members whose business activity outside the United States is 80% or more of any such member's total business activity").

<sup>62</sup>For discussion of Walmart's use of a foreign entity to defeat Illinois's combined reporting regime, see Jesse Drucker, "Why Wal-Mart Set Up Shop in Italy," *The Wall St. Journal*, Nov. 14, 2007, at C1.

<sup>63</sup>Mich. Comp. Laws Ann. section 208.1109(5) (West Supp. 2007). Active foreign business income is defined in IRC section 861(c)(1)(B) (2008).

authorities to require the inclusion of a U.S. company in the unitary business group when necessary to prevent abusive tax avoidance.

## VI. Conclusion

The governor and Legislature undoubtedly hope that the MGRT will contribute to the economic development of Michigan. From an economic development perspective, the new tax is a decided improvement over the SBT in its treatment of imports and exports. It generally taxes the value added attributable to imports and does not tax the value added attributable to exports, whereas the opposite was true of the SBT for most of its history.

As with just about any tax, the incidence of the MGRT is not entirely clear. If we accept the assumption by most economists that under typical economic conditions the tax imposed by a VAT will be shifted partially or fully forward to consumers, it is reasonable to assume the same result for the MGRT. Although the MGRT differs in the mode of collection from the credit-subtraction VATs found in Canada, Europe, and most other countries, it still has most of the features of a VAT.

A tax on consumers is not necessarily good for economic development. One should not assume that a tax advances economic development merely because the tax is popular with business interests. Most countries that have been successful economi-

cally have created a strong market for their businesses through the fostering of a prosperous middle class. Hammering the middle class with heavy taxes on consumption is not only unfair — it may also be detrimental to economic development.

***The major benefit of the MGRT will probably be that it provides Michigan with a stable and relatively neutral source of revenue.***

That said, the economic effects of the new tax are not likely to be substantial. With a rate less than 1 percent and most cascading effects eliminated, the MGRT surely does not lay a heavy tax on consumers even if they are its real taxpayers. The broad scope of the tax (in terms of the firms included and the goods and services covered), coupled with the low rate, will prevent the tax from having significant effects on business choices, although the double tax on some services is cause for concern. In the end, the major benefit of the MGRT will probably be that it provides Michigan with a stable and relatively neutral source of revenue. In our view, a state cannot expect to project a positive image to investors if it is having well-publicized problems, year after year, in paying its bills. ☆