Michigan: Taxpayers entitled to apportion income under Multistate Compact three-factor election

July 16, 2014

In brief

On July 14, 2014, the Michigan Supreme Court, in a 4-3 decision with one Justice issuing a separate concurring opinion, held that International Business Machines Corporation (IBM) was entitled to use the Multistate Tax Compact's elective three-factor apportionment formula to calculate its 2008 Michigan business tax. The court further held that the modified gross receipts component of the tax fit within the broad definition of an income tax under the Compact, thereby allowing IBM to use the Compact's elective formula for this portion of the tax base. [*International Business Machines Corp. v. Department of Treasury*, Docket No. 146440, July 14, 2014]

In detail

Background

In 2009, IBM filed its Michigan Business Tax Return for the 2008 tax year, attaching a statement to the return titled "Election to use MTC Three Factor Apportionment," indicating its election to apportion business income and the modified gross receipts tax base using an equally weighted three-factor apportionment formula codified in Michigan law. IBM sought a refund of approximately $6 million.

The Department of Treasury (Department) determined IBM could not use the Compact election to apportion its tax base and denied most of the refund claim. IBM filed a complaint in the Court of Claims challenging the Department's determination and moved for summary disposition. The Department also moved for summary disposition. The Court of Claims denied summary disposition to IBM and granted the Department's motion. In an unpublished decision, the Court of Appeals affirmed the Court of Claims order granting summary disposition in favor of the Department. The Court of Appeals concluded that the Michigan Business Tax Act (BTA) repealed by implication the election provision found in the Compact. (Click here for our summary of the appellate court decision.) IBM sought leave to appeal before the Michigan Supreme Court (Court), which reviews de novo Court of Claims decisions on motions for summary disposition and issues of statutory interpretation. The Court granted leave, asking the parties to address specific questions in their briefings.

To determine whether IBM could use the Compact's three-factor apportionment formula to calculate its 2008 Michigan tax, the Court first looked at the history of business taxation in Michigan. It noted that Michigan joined the Multistate Tax Compact in 1970. When the state enacted the Single Business Tax in 1976, it did not expressly repeal the Compact. When it enacted the BTA in 2008, it also did not expressly repeal the Compact. Effective January 1, 2011, Michigan

modified the Compact language in an attempt to limit the ability of taxpayers to elect to apportion under UDITPA's three factor method contained in the Compact. Effective January 1, 2012, Michigan returned to a corporate income tax. The Court noted that throughout the evolution of the state's business taxation, the Compact has remained in effect, regardless of the mandatory apportionment language contained in Michigan's tax statutes. The Court also noted that the language of the Compact when adopted anticipated that the state's method could differ from the Compact method at some point in the future.

Repeals by implication

The Court stated that the determination of whether IBM could elect to use the Compact's three-factor formula was based on whether the legislature repealed the election provision by implication when it enacted the BTA. The Court first noted that if the legislature had intended to repeal a statutory provision, it would have done so explicitly. Repeals by implication are disfavored and allowed 'only when the inconsistency and repugnancy are plain and unavoidable.' The Court will construe statutes that are claimed to be in conflict harmoniously by finding 'any other reasonable construction' than repeal by implication.

The Court noted that the election provision allows a taxpayer to elect to use a Compact member state's apportionment formula or the Compact's three-factor apportionment formula. Michigan's statutory provisions imposed a mandatory sales factor apportionment formula under the BTA. While the Department argued the state's mandatory language precluded the use of any other apportionment formula, the Court ruled that it could not look at the Michigan statutory provision 'in a vacuum.'

The Court found that the Department's argument overlooks the Compact's election provision, which 'contemplates a divergence between a party state's mandated apportionment formula and the Compact's own formula – either at the time of the Compact's adoption by a party state or at some point in the future. Otherwise, there would be no point in giving taxpayers an election between the two.' Viewed in this light, the Court held the BTA's mandatory apportionment language may be regarded as compatible with the Compact's election provision and read as a harmonious whole. Had the legislature believed the election provision conflicted with the BTA, it could have taken the necessary action to eliminate the election provision as it had done with other business tax provisions.

In a footnote, the Court dismissed the Department's alternative argument that the BTA and Compact could be harmonized only through the use of the alternative apportionment provision, which allows a taxpayer to petition to use another apportionment formula. The Court found the Department's position would be an 'abrogation of the election provision' because the Department's position takes the choice out of the taxpayer's hands and is inconsistent with the plain language of the Compact.

Based on these findings, the Court stated that the Department failed to overcome the presumption against repeals by implication.

Legislative repeal of the election

On May 25, 2011, the legislature expressly amended the Compact's election provision by adding language that provides 'except that beginning January 1, 2011 any taxpayer subject to the Michigan business tax act . . . or the income tax act of 1967 . . . shall, for purposes of that act, apportion and allocate in accordance with the provisions of that act and shall not apportion or allocate in accordance with [the Compact].' The Court noted that the legislature could have – but did not – extend the retroactive appeal to the start date of the BTA. By only repealing the Compact's election starting in 2011, 'the legislature created a window in which it did not expressly preclude use of the Compact's election provision for BTA taxpayers.' The Court further found the express repeal is evidence the legislature had not impliedly repealed the provision when it enacted the BTA. The one concurring Justice did not believe the implied repeal needed to be addressed 'because the legislature made it clear' the election was available.

The modified gross receipts tax

The BTA tax base has two components: an income tax and a modified gross receipts tax (MGRT). The Compact election is available to any taxpayer subject to an income tax. The Department argued that the MGRT is not an income tax but, rather, a gross receipts tax. The Court disagreed and held the MGRT fits within the broad definition of 'income tax' under the Compact by taxing a variation of net income. That is, the entire amount received by the taxpayer as determined by any gainful activity minus inventory and certain other deductions. Therefore, the Court held IBM could elect to use the Compact apportionment formula for the MGRT portion of the tax base.

The dissent

Three members of the Court dissented, finding the threshold issue at its core is one of statutory interpretation. The dissent disagreed

that reconciliation of the BTA and Compact was possible. Finding the two provisions irreconcilably in conflict, the dissent stated that the subsequently enacted BTA mandatory sales-only apportionment legislation must control.

The dissent reasoned that if a taxpayer can elect an alternative apportionment, then the mandatory provisions of the BTA are 'in no sense mandatory,' but, rather, 'optional.' The dissent stated that the majority had not persuasively explained why the BTA did not impliedly amend or repeal the Compact's election provision.

The dissent also addressed IBM's argument that the legislature was not constitutionally permitted to make the BTA's sales-only apportionment formula exclusive without first repealing the Compact in its entirety. The dissent stated that compacts without congressional approval are not transformed into federal law. Thus, their construction is a matter of state statutory law. The dissent found IBM's argument that the Compact supersedes conflicting state law contrary to the well-established rule that a statute can be amended, repealed or superseded in whole or part, expressly or impliedly, by a subsequent enacted statute. The dissent opined that the legislature is prohibited from unilaterally amending the Compact 'only if that amendment impairs contractual obligations created by the Compact itself.'

The dissent found the states' courses of conduct are critical to understanding the nature of the agreement and in this case actions indicate there is no contractual obligation to adhere to the Compact's election provision. The dissent also noted that the Compact is silent regarding a member state's authority to enact exclusive apportionment formulas that differ from the Compact's formula.

The dissent concluded by stating it would have affirmed the judgment of the Court of Appeals because: (1) allowing taxpayers to apportion their income in accordance with the Compact's formula violates the BTA's sales-only formula and (2) since the state was not contractually obligated to allow taxpayers to make the election, the BTA does not offend state or federal constitutions.

The decision raises questions for taxpayers on actions to take for years 2011 and later. Please call your PwC State and Local Tax contact to further discuss this matter.

Let's talk

For more information on the *IBM* decision, please contact:

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