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Michigan Court of Appeals Decision Holding that Sale of Stock Entitled to Use Alternative Apportionment Has Broad Implications

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OVERVIEW

Vectren Infrastructure Services Corp., successor-in-interest to Minnesota Limited, Inc., v. Dept. of Treasury (MLI)[1] involves the sale of interests in an S corporation in 2011 for a gain of $80 million where the seller made an §338(h)(10)[2] election (and the S corporation was therefore the taxable entity that recognized the gain). As the Michigan Court of Appeals (Court) noted, ''[t]his case presents the complex question of how the gain on the sale of an out-of-state business, which conducts some of its business activities in Michigan, should be [apportioned and] taxed under the Michigan Business Tax.''[3] The Court ultimately held that the application of the statutory formula by the Michigan Department of Treasury (Department) ''would result in the imposition of a tax in violation of the Commerce Clause.''[4] Therefore, the Court held that MLI's use of an alternative apportionment formula was ''necessary to avoid the constitutional violation.''[5]

EXECUTIVE SUMMARY

MLI stands for the proposition that a statutory formula frequently does not fairly apportion gain from the sale of a multistate business interest and, therefore, demonstrates the importance of exploring alternative methods of apportioning gain that may yield substantially lower tax liabilities:

- In this case the Court held that the Michigan statutory single sales factor formula did not fairly apportion the gain from the sale of S corporation stock, but the Court's rationale may be applied to the sale of any multistate business interest.
- The Court held that because the increase in value of the S corporation stock resulted from many years of effort and multiple factors that had occurred in multiple states, Michigan's statutory single sales factor – which looked only to the year of sale – did not fairly apportion the gain.
- It is virtually impossible for every statutory formula to apportion fairly the gain from the sale of stock (or **any other interest** in a multistate enterprise) in every situation, and depending on the formula, the results can vary widely.
- In this case the stakes were high, the Department applied the statutory formula to assess MLI close to $3 million by asserting that 70% of the gain was taxable in Michigan, while the taxpayer claimed that only 15% should be taxed in Michigan.
- Because the Court found that the statutory formula was unfair, it remanded the case for the parties to agree on an alternative formula that fairly (i.e., constitutionally) reflects MLI's business activity in Michigan.

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[1] No. 345462, slip op. 1 (Mich. Ct. App. Mar. 12, 2020), *available at* https://aboutbtax.com/PQQ.

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] *MLI*, No. 345462, slip op. at 1.

[4] *MLI*, No. 345462, slip op. at 4.

[5] *MLI*, No. 345462, slip op. at 4.

FACTS

MLI, headquartered in Minnesota, was engaged in the business of constructing, maintaining, and repairing oil and gas pipelines. MLI started as a family business and had grown over the course of its 52-year history to employ more than 600 people in 24 states. MLI's service territory primarily included locations in the northern Midwest, such as Minnesota, Wisconsin, Iowa, and the Dakotas, including some years in Michigan. MLI's business was primarily from projects and generally not recurring. As a result, the states in which MLI conducted business activities varied from year to year. MLI never maintained a permanent business location in Michigan or retained permanent employees in the state.

While MLI was seeking a buyer in the summer of 2010, it performed services to clean up an oil pipeline spill in Michigan and brought minimal equipment and employees into Michigan to perform the services on this project. While this Michigan project was still ongoing, MLI sold all its assets on March 31, 2011, including capital assets and intangible assets of receivables, retainages, cash, prepaid expenses, inventory and goodwill, to Vectren, referred to as the ''Sale'' herein.

MLI included the gain on the Sale, referred to as the ''Gain'' herein in its tax base and in the denominator of its sales factor, which resulted in a 15% Michigan apportionment percentage.[6] On audit, the Department included the Gain in the tax base but excluded it from the denominator of MLI's sales factor, which resulted in a 70% apportionment percentage. As a result, the Department assessed close to $3 million in tax, including interest and penalties.

In the court of claims, MLI argued that (a) not including the Gain in the denominator of its sales factor was constitutionally distortive (sourced to Michigan income out of all proportion to MLI's business activity in Michigan) and required alternative apportionment; (b) the Gain was nonoperational and therefore the constitution precluded any of the Gain from being taxed in Michigan; (c) the Gain was nonbusiness income allocable outside Michigan; and (d) the penalty should be abated. The court of claims affirmed the Department's assessment finding that the Gain was business income and MLI had generally not met its burden of proof and did not abate the penalties.

ANALYSIS

The Court set the framework for its analysis by first recognizing ''the difficulty in identifying purely intrastate activity when a unitary business is involved,'' and noting that ''the United States Supreme Court has not required the use of a particular formula to the exclusion of others.''[7] Instead, the Court stated, the formula applied must be ''fair'' and that the ''choice of factors used in the formula must actually reflect a reasonable sense of how the business activity is generated.''[8]

Before diving into the details of its reasoning, and because the taxpayer had clearly presented sufficient evidence to support its position, the Court quickly concluded that MLI had ''presented clear and cogent evidence that the statutory formula, as applied, attributed business activity to Michigan out of all appropriate proportion to the actual business activity transacted in the state . . . and led to a grossly distorted result, and also operated to unconstitutionally tax extraterritorial activity.''[9] The Court found that MLI had built up its value of over many years and that value was ''attributable to activity in many states . . . much of [such] activity never had any connection to Michigan.''[10] Here, because the application of the statutory formula yields ''an unreasonably large portion of the Sale . . . attributed to Michigan [70% causes] the apportionment formula [to be] unconstitutional as applied to MLI under the circumstances of this case.''[11]

After reviewing some of the salient Supreme Court cases on fair apportionment (*Hans Rees,*[12] *Container*[13] and *Trinova*[14]) the Court found that ''[w]hile some of MLI's value can undoubtedly—and should undoubtedly—be attributed to its business activity in Michigan, the undisputed history of MLI's sales in the state is that those sales averaged around 7 percent of its total sales, are evidence that well over a majority of the value inherent in MLI stemmed, not from its activity in Michigan . . . but from intangible assets built up in multiple other states over time.''[15] Therefore, taxing 70% Gain when ''the majority of the activities making up MLI's fair market value at the time

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[6] For the year at issue, the MBT tax base was apportioned based on a single sales factor.

[7] *MLI*, No. 345462, slip op. at 4.

[8] *MLI*, No. 345462, slip op. at 4 (internal quotations omitted).

[9] *MLI*, No. 345462, slip op. at 5 (internal quotations and citations omitted).

[10] *MLI*, No. 345462, slip op. at 5.

[11] *MLI*, No. 345462, slip op. at 5.

[12] *Hans Rees' & Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931).

[13] *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

[14] *Trinova Corp. v. Mich. Dept. of Treas.*, 498 U.S. 358 (1981). The Court also discussed *Panhandle Eastern Pipe Line Co. v. Michigan Corp. & Securities Comm.*, 346 Mich. 50, 56; 77 N.W.2d 249 (1956) (holding ''the formula used by the commission includes receipts from a business not related to plaintiff's intrastate business. . .'').

[15] *MLI*, No. 345462, slip op. at 7.

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of the Sale had occurred outside Michigan's borders'' would ''create an unconstitutional distortion.''[16]

After finding that penalties were to be abated, the Court declined MLI's request to impose a particular alternative method of apportionment, remanded the case for the parties to determine the appropriate alternative formula, and ''encourage[d] the parties to engage in a good-faith collaboration to arrive at such a method.''[17] In doing so, the Court reminded the parties that ''just as the Department may not rely on the statutory formula in this case, neither can it insist on an alternate method that does not cure the constitutional defect by continuing to attribute out-of-state revenue to Michigan.''[18]

The Court's order remanding this case to determine an appropriate alternative apportionment method could be read to suggest that the single sales factor just might not appropriately reflect MLI's business activity in the state. Earlier in its opinion, citing *Container*, the Court acknowledged that the ''three-factor formula had gained wide approval because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated.''[19] Then, in finding that *Trinova* does not support the Department's position, the Court recognized that ''the MBT uses a single [sales] factor [and], unlike the three-factor formula in Trinova, ***MLI's Michigan sales alone do not reasonably reflect how the [G]ain on the Sale was generated.***''[20] More broadly, one wonders whether MLI supports the argument that, as applied in certain circumstances, the single sales factor may not necessarily fairly reflect a taxpayer's business activity.

CONCLUSION

Any taxpayer who has sold – or is planning to sell – any sort of interest (including S corporation stock, C corporation stock, partnership of limited liability company interest, etc.) in a multistate business should first determine the tax liability yielded by the statutory formula. Next, the taxpayer should identify the factors that have contributed to creating the increase in value of the business interest. Having identified those value-creating factors, the taxpayer should analyze whether the statutory formula takes them into account and, if so, whether it attributes proper weight to them. If the statutory formula does not fairly reflect the value-creating factors, the taxpayer should explore alternative methods of apportionment that would fairly reflect the manner in which the gain was created and, which may, in turn, yield a more favorable tax result than the statutory formula.

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[16] *MLI*, No. 345462, slip op. at 7. The Court also ''briefly'' addressed the Department's claim that MLI had not ''follow[ed] the statute's procedural requirements by petitioning for alternative apportionment before filing its MBT return'' and not requesting to use an alternative method until after audit. *MLI*, No. 345462, slip op. at 8. The Court found that the Department had waived this argument because the Department: (a) entertained the request at the informal level; and (b) did not raise this argument until the Court of Appeals. *MLI*, No. 345462, slip op. at 8.

[17] *MLI*, No. 345462, slip op. at 8.

[18] *MLI*, No. 345462, slip op. at 8-9.

[19] *MLI*, No. 345462, slip op. at 6 (internal citations omitted).

[20] *MLI*, No. 345462, slip op. at 8 (emphasis added).

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