

Jurisdictional Standards

Who is subject to the Single Business Tax? Who must file a Single Business Tax Return?

The Single Business Tax is imposed on any “person” engaged in a “business activity” in Michigan.

A taxpayer whose business activities are taxable both within and without this State shall apportion his tax base as provided in Chapter 3 (MCL 208.40 through MCL 208.69) of the Single Business Tax Act. (MCL 208.416)

History of The Michigan Nexus Standard

The Michigan Single Business Tax Act was passed in August of 1975 effective for tax years starting on or after January 1, 1976. The new tax, a value added tax, replaced eight other taxes. Development of a nexus standard was a perplexing problem because Michigan was the only state with a value added tax, therefore no precedent existed in this country.

In 1976, the Michigan Department of Treasury adopted a dual nexus standard. For non-Michigan based businesses doing business in Michigan, the standard was a Commerce Clause nexus standard as promulgated by the United States Supreme Court. The minimum standard was physical presence through either an employee or independent contractor.

For a Michigan based business or a business shipping tangible property from a store or warehouse located in Michigan for out of state delivery, nexus for throwback purposes was based on Federal Public Law 86-272. The federal stop-gap legislation, enacted by congress in 1959, prevents a state from imposing its income tax upon a taxpayer whose only activity carried on within a state is solicitation of orders for sale of tangible personal property with approval and delivery from outside the state.

After much opposition from business and professional groups, the Department of Treasury changed its policy in 1980 to one standard to be consistently applied to both foreign businesses selling into Michigan and for throwback purposes. This policy was promulgated in Single Business Tax Bulletin 1980-1 titled Jurisdictional Standard. The standard was Public Law 86-272 to be applied both ways. The Department of Treasury was correct in adopting a single standard, however, they adopted the wrong standard. Public Law 86-272 applied to only income taxes. The Single Business Tax was a value-added tax. Notwithstanding this fact, the federal standard became the state’s policy and stayed in effect for 14 years until 1994.

The Department of Treasury's thinking was influenced by theories of apportionment designed to apportion tax base among the states with all the tax base apportioned to some state. The Michigan statute adopted language from UDITPA (Uniform Division of Income for Tax Purposes Act). The State of Michigan has been a long time member and supporter of the Multi-State Tax Compact.

The Federal Public Law 86-272 Nexus Policy continued until 1994. Then a United States Supreme Court case and two Michigan Circuit Court of Appeals cases moved the Michigan Department of Treasury to change its nexus policy again.

Quill Corporation v. North Dakota, 504, U.S.; 112 Supreme Court 1904 (1992)

The U.S. Supreme Court held that North Dakota's attempt to impose use tax on goods purchased by North Dakota residents from an out-of-state mail order seller that did not have outlets or sales representatives in the state violated the Commerce Clause of the U.S. Constitution. The High Court's decision reversed a North Dakota Supreme Court decision that the mail order seller had sufficient connection with North Dakota to justify the use tax on in-state purchases.

The North Dakota Supreme Court held that, in light of the U.S. Supreme Court's decision in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), and subsequent High Court decisions, the state was no longer obligated under the Commerce Clause to demonstrate that a mail order seller had a physical presence within the state in order to tax purchases by North Dakota residents. The High Court set out the physical presence requirement in its decision in *National Bellas Hess, Inc. v. Illinois Dept. of Revenue*, 386 U.S. 753 (1967).

According to the U.S. Supreme Court, however, the *National Bellas Hess* Commerce Clause analysis is still valid. *National Bellas Hess* concerns the first part (substantial nexus) of the four-part *Complete Auto Transit* Commerce Clause test and signifies that a seller whose only contacts with the taxing state are by mail or common carrier lacks the substantial nexus required by that clause. Further, High Court decisions after *National Bellas Hess* do not invalidate the physical presence requirement of that case because the later cases concerned other types of taxes.

Rather, the continuing usefulness of the physical presence requirement and the principle of stare decisions indicate that the requirement is still good law.

However, the High Court held that the Due Process Clause does not bar North Dakota's enforcement of the use tax against the mail order seller, even though the Commerce Clause does. In the years since *National Bellas Hess*, the High Court has abandoned formalistic tests focused on the taxpayer's presence in the state. More recent High Court decisions have focused on the question of whether the taxpayer had sufficient contacts with the taxing state to make it reasonable to require it to defend itself against suits there. Consequently, to the extent that previous High Court decisions have indicated that the Due Process Clause requires a seller's physical presence in the state in order for the state to tax its sales, those decisions are overruled.

In this case, the taxpayer has sufficient minimum contacts with North Dakota to satisfy Due Process Clause requirements because the taxpayer had purposefully directed its activities at North Dakota residents, its sales were of sufficient magnitude and the tax was related to the benefits it had received from the state.

Nevertheless, even though the seller had sufficient minimum contacts to validate the state tax under the Due Process Clause, the tax was invalid because the seller lacked the substantial nexus with the state required by the Commerce Clause.

The requirements of the two clauses spring from different constitutional concerns and policies. Due Process Clause analysis concerns the fundamental fairness of governmental activity and its touchstone is notice or fair warning. Commerce Clause analysis, in contrast, concerns the effect of state regulation on the national economy. Consequently Congress is better qualified than the courts to resolve the underlying Commerce Clause issue in this case.

Guardian Industries Corporation v. Department of Treasury, 198 MICH APP 363; 499 NW 2d 346 (1993)

Guardian was a Michigan based company and the main issue was the throwback of sales for apportionment. However, Guardian was significant because it rejected the use of Public Law 86-272 and instead relied on Scripto. Whether the taxpayer's solicitation of sales in another state provides a sufficient nexus for the state to impose a business privilege-type tax depends on the jurisdictional standard employed. The Department argued that the standard should be based on either PL 86-0272 or the Multistate Tax Compact, or based on both. However, the Court of Claims rejected use of either PL 86-272 or the Multistate Tax Compact as the proper jurisdictional standard because both relate to the imposition of a tax on income rather than a tax on the privilege of doing business. Since no jurisdictional standard has been legislated, the court held that constitutional due process was the proper jurisdictional standard to be applied.

Under the due process nexus standard, a state may impose a business privilege-type tax on a person or activity if only a minimal connection exists between the state and the person or activity. In this case, the taxpayer's solicitation activities in the sales destination states consisted of calling on customers and potential customers, taking orders, and forwarding comments and complaints to the plant located in Michigan.

Citing U.S. Supreme Court cases, the court held that these activities were sufficient to permit the sales destination states to impose a business privilege-type tax on the taxpayer (regardless of whether, in fact, the other states impose such a tax). Under this standard, the taxpayer was taxable in other states, and sales attributable to those states could not be included in the numerator of the sales factor.

Gillette Company v. Department of Treasury, 198 MICH APP 303; 497 NW 2d 95 (1993)

The Court of Appeals decision in Gillette did not involve the throwback test, but looks instead to when Michigan itself would have jurisdiction to impose the Single Business Tax on a foreign taxpayer selling in Michigan.

Prior to the 1976 enactment of the Single Business Tax, Gillette's activities in Michigan had been structured so as to come within PL 86-272 permitted *solicitation*. When the Single Business Tax was enacted, the Department at first asserted that it would not apply the PL 86-272 test, given that it literally applied only to income taxes. After several years the Department reconsidered and decided to apply the PL 86-272 test as a matter of administrative policy. It first publicly announced this in its Single Business Tax Bulletin 1980-1, reiterated this in Revenue Administrative Bulletin 89-49, and confirmed this approach in 1986, by signing the Multi-State Tax Commission's Resolution regarding the Adoption of Statement of Information concerning Practices of Multi-State Tax Commission States under Public Law 86-272, certifying that it administratively applied the PL 86-272 test to determine jurisdiction to tax under the SINGLE BUSINESS TAX Act.

Gillette was encouraged by these developments. Not only had it organized its Michigan activities to be within permitted PL 86-272 *solicitation*, but it had also just litigated this issue through New York's highest court, which held for Gillette on the PL 86-272 issue.

The Michigan Department, while dropping the corporate income tax deficiency audit against Gillette for income tax years 1974 and 1975 because Gillette's activities were permitted solicitation under PL 86-272, nevertheless refused to drop its SINGLE BUSINESS TAX deficiency assessments for the years 1976 through 1981. The Michigan Tax Tribunal found for the Department, finding Gillette's activities exceeded permissible *solicitation* under PL 86-272. Gillette appealed to the Michigan Court of Appeals. While that appeal was pending the U.S. Supreme Court decided the first case involving construction of the *solicitation* language in PL 86-272. In Wisconsin Dept. of Revenue v Wrigley Co., US; 112 S Ct 2447 (1992), the U.S. Supreme Court applied a definition of *solicitation* which was believed by Gillette to be of significant assistance. The Court of Appeals was so informed by supplemental brief.

The Court of Appeals, next, unexpectedly, without notice and acting suspicious after all briefs and oral arguments had been submitted, determined, as an issue of first impression, that PL 86-272 did not literally apply to the SINGLE BUSINESS TAX, a fact which the Department had known and announced 18 years earlier. The Court of Appeals, apparently unaware of the 17-year Departmental administrative policy intentionally adopting and applying PL 86-272 as the SINGLE BUSINESS TAX jurisdictional test, fashioned a new test under the recent U.S. Supreme Court decision in Quill Corp v North Dakota, 504, US; 112 S Ct 1904 (1992). Under that test, Gillette's presence in Michigan was more than adequate to give the state jurisdiction, and the Court of Appeals, never addressing the PL 86-272 issue or acknowledging the long-standing state administrative policy uniformly applying PL 86-272 to all similarly situated potential taxpayers, retroactively ordered the new test applied to Gillette back to 1976.

In 1994, the Department of Treasury dropped Federal Public Law 86-272 as its nexus standard in favor of the "physical presence" standard as enumerated in the Quill decision. Many problems remain as to what extent of physical presence would constitute "nexus".

While the Department of Treasury was struggling with a definition of “physical presence” another nexus concept emerged from a South Carolina income tax case.

Syntex Laboratories V. Department of Treasury, Michigan Court of Appeals, No. 196546, December 29, 1998

The retroactive application of the nexus test from *Quill Corp.*, 504 U.S. 298 (1992), to impose Michigan single business tax liability did not violate a taxpayer’s constitutional rights to due process of law or equal protection even though non-filing potential taxpayers were not required to pay the tax for the same period.

Nexus Issues

Before 1993, the taxpayer claimed that, under the standards set forth in federal P.L. 86-272, it had insufficient nexus with Michigan in 1982 and 1983 to permit assessment of single business tax. P.L. 86-272 prohibits any state or political subdivision from imposing a net income tax on income derived within a state from interstate commerce if the only business activity within the state is the solicitation of orders for the sale of tangible personal property, the orders are sent outside the state for approval or rejection, and, if approved, the orders are filled by shipment or delivery outside the state. However, in *Gillette Co.*, 198 Mich.App. 303,497 N.W.2d 595 (1993), the Michigan Court of Appeals held that P.L. 86-272 did not apply to the tax and that the nexus test from *Quill* was applicable. In *Quill*, the U.S. Supreme Court held that physical presence is required by federal Commerce Clause in order for a state to require an out-of-state vendor to collect the state’s use tax on sales the vendor makes into the state, but that physical presence is not required to satisfy federal Due Process Clause Requirements. As a result of the *Gillette* decisions, the Department of Treasury notified non-filing potential taxpayers that they were no longer protected by P.L. 86-272 and asked them to voluntarily pay single business tax for 1989 to 1993 with interest but no penalty.

The taxpayers in this case, however, were not offered this option. The taxpayers maintained that the *Quill* standard could not be applied retroactively to its 1982 and 1983 tax years and that the Department could not impose single business tax liability on it those years while limiting non-filing taxpayers’ liability to tax years from 1989 on.

Equal Protection

The application of *Quill* standard to the taxpayer for 1982 and 1983 did not violate the taxpayer’s federal and state constitutional rights to uniform taxation because the taxpayer was not similarly situated to the non-filing potential taxpayers. Unlike the non-filing taxpayers, the taxpayer had matters pending before the Department of Treasury, knew that the *Gillette* decision could affect these matters, and had prior notice that it would be liable for single business tax for years before 1989. The Department of Treasury’s enforcement decision was supported by the availability of records, the non-filing potential taxpayers’ reliance on its bulletins, and its limited resources.

Due Process

The taxpayer’s federal and state due process rights also were not violated. There was a rational basis for the Department of Treasury’s decision to enforce the nexus standard

announced in Gillette. The retroactive application of the nexus standard was permissible because the decision reached in Gillette was not unexpected and the taxpayers did not have a vested right in the continuation of a tax law. (Syntex Laboratories, Michigan Court of Appeals, No. 196546, December 29, 1998.)

Michigan Judicial Decisions From 1997

In **MagneTek** the courts focused on the Commerce Clause standard of taxability as the appropriate measure of activity in a foreign state to avoid inclusion in the numerator of the sales factor of the apportionment formula under Section 42 of the Single Business Tax Act. In reaching its decision in Magnetek, the court determined that Magnetek's sales manager and product line managers had spent in excess of 10 days per year in several states. The court ruled that this activity, while protected from being subjected to a tax on net income, did create nexus under the Commerce Clause nexus standard as interpreted by current case law. Sales to customers in these states were therefore excluded from the numerator of the sales factor.

In **National Steel** employee, sales representatives documented their presence in the destination states in question between 3 and 89 days per year. The court stated "The ultimate question is whether that business activity provides sufficient nexus between Plaintiff and the destination states to warrant their imposing, should they choose to do so, some sort of business privilege tax on plaintiff. The answer hinges on the whether such states meet the jurisdictional standard of the Commerce Clause, US Const. Art I, § 8."

Accordingly, the Court of Claims rejected the Department's contention that a "permanent" in-state sales force "continuously" soliciting customers was required to establish nexus in the outbound state. In the opinion of the court, "Plaintiff's business activities of sales solicitation within the destination states were sufficient to render it taxable by those jurisdictions within the meaning of section 42 of the SBTA."

In **Michigan Sugar** the Department of Treasury again determined "because Petitioner did not file, report or pay business income taxes to any other state, and because Petitioner had no payroll or property outside Michigan, all sales were deemed to be Michigan sales. . ." The Department urged the Tribunal to determine that only a "permanent or continuous" physical presence of the company in a target state is sufficient to satisfy Commerce Clause nexus. The Tribunal concluded "Rather than requiring a taxpayer to demonstrate a permanent or continuous physical presence * * * [Northwestern States Portland Cement Company v Minnesota, 358 US 450; 79 S Ct 357; 3 L Ed 2d 421 (1959)] demonstrate[s] that substantial nexus can be satisfied through a finding of regular and systematic physical presence." The Tribunal also added a relative business volume consideration to the number of visits required to establish nexus.

Accordingly, the Tribunal denied Michigan Sugar's claim of nexus in Minnesota where ten or more visits were made each year but sales volume was relatively small. In contrast, an Illinois resident nonexclusive sales representative solicited significant sales volume from an undisclosed number of visits to a single Indiana customer. In applying the test of related business activity, the Tribunal found nexus to exist in Indiana.

In **Gear Research** the Tax Tribunal ruled a Michigan company satisfied the nexus requirement in New York and New Jersey through its use of an independent commission sales representative living and working in those states. The Tribunal did not accept an undocumented statement that the sole employee salesman regularly made sales calls to customers in Indiana on Fridays as satisfying the burden of proof that Gear Research has the requisite nexus in Indiana.

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