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SFA BILL ANALYSIS

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Senate Bill 872 (Substitute S-1 as reported)
Senate Bill 890 (as reported without amendment)
Sponsor: Senator Joanne G. Emmons
Committee: Finance

Date Completed: 2-25-98

RATIONALE

In recent years, there have been several court cases and a Department of Treasury ruling that affect the calculation of a firm's sales for purposes of the single business tax (SBT). The SBT is based upon a measure of business activity in Michigan. A firm that conducts all of its activities in this State must include all of those activities in its tax base. In the case of a multistate firm (either located outside of Michigan and doing business in this State, or headquartered in Michigan and doing business in this and other states), the company must determine how much of its business activity is attributable to Michigan. This is accomplished by using a weighted three-factor formula that calculates the ratio of the firm's property, payroll, and sales in Michigan to its entire property, payroll, and sales. The firm then must apportion its tax base accordingly. For purposes of apportionment, the SBT Act provides that a taxpayer is taxable in another state if a) in that state, the taxpayer is subject to a business privilege tax, a net income tax, a franchise tax measured by net income, a corporate stock tax, or a tax of the type imposed under the Act, or b) that state has jurisdiction to subject the taxpayer to any of the taxes regardless of whether the state actually does so.

In regard to the sales factor, the Act also specifies that a sale of personal property is attributable to Michigan if the taxpayer is not taxable in the state where the property is purchased. Referred to as the "throwback rule", this applies to situations in which property is shipped from a location in Michigan to a purchaser in another state. Several Michigan Court of Appeals decisions have addressed the throwback rule in view of a 1992 decision of the U.S. Supreme Court (*Quill Corp.* v *North Dakota*, 504 US 298). In general, for a state's tax to be constitutional, a taxpayer must have sufficient "nexus", or connection, with the state imposing the tax. In determining whether sufficient nexus exists, the courts have indicated that a degree of physical presence is necessary; while the presence need not be substantial, it must be more than slight. In February 1997, the Michigan Court of Appeals held that the physical presence requirement can be satisfied by the conduct of economic activities in the taxing state.

The Court of Appeals decisions are relevant to the throwback rule because, if a single business taxpayer has sufficient nexus within another state where sales are made, the rule will not apply. According to the Michigan Department of Treasury, the decisions have invalidated the Department's previous reliance on Federal law with respect to nexus. As a result, in Revenue Administrative Bulletin (RAB) 98-1, the Department has issued new SBT nexus standards. Since the new standards apply to "all open tax periods ending on or after January 1, 1989", some taxpayers could incur substantial penalties for single business taxes they owe for past years. To encourage these firms to pay their taxes, it has been suggested that they should be allowed to enter into agreements with the Department under which no penalties would be imposed for unpaid taxes. In addition, since the Department has issued specific new nexus standards, it has been suggested that the statutory throwback rule should be eliminated.

CONTENT

Senate Bill 872 (S-1) would amend the revenue Act to allow the Revenue Commissioner or an authorized representative of the Commissioner, on behalf of the Department of Treasury, to enter into a voluntary disclosure agreement with a person to bring nonfilers into compliance for taxes due or claimed by the State. (A

"nonfiler" for a particular tax would be a person who had never filed a return for the particular tax being disclosed.) All taxes and fees administered under the Act would be eligible for inclusion in a voluntary disclosure agreement. A person would have to meet specific eligibility requirements, including agreeing to pay all taxes for a "lookback period" and after the lookback period. The Department of Treasury could not assess any tax, penalty, or interest covered under an agreement for any period before the lookback period.

<u>Senate Bill 890</u> **would amend the Single Business Tax Act to limit to tax years beginning before January 1, 1998, the provision that sales of tangible personal property are in this State if the taxpayer is not taxable in the state of the purchaser.**

The bills are tie-barred to each other. <u>Senate Bill 872 (S-1)</u> is described in more detail below.

<u>"Lookback period"</u>

The bill would define "lookback period" as one or more of the following:

- -- The most recent 48-month period as determined by the Department or the first date the person subject to an agreement began doing business in the State if less than 48 months.
- -- For single business taxes, the four most recent completed fiscal or calendar years over a 48-month period or the first date the person subject to an agreement began doing business in this State if less than 48 months.
- -- If there were doubt as to liability for the tax during the lookback period, another period as determined by the Commissioner to be in the best interest of the State and to preserve equitable and fair administration of taxes.

<u>Eligibility Criteria</u>

To be eligible for a voluntary disclosure agreement, a person could not have had any previous contact by the Department or its agents, including the Multistate Tax Commission, regarding a tax covered by the agreement (except as provided below). ("Previous contact" would mean any notification of an impending audit, review, or any type of notice of assessment. Previous contact would include final letters of inquiry (stating the Department's opinion that the taxpayer needed to furnish further information or owed taxes to the State), a subpoena from the Department, and any other contact designated as a previous contact by the Department in an interpretive statement, guideline, or informational pamphlet.)

Also, the person could not have had any notification of an impending audit by the Department or its agents, and could not currently be under audit by the Treasury Department or under investigation by the Department of State Police, the Department of Attorney General, or any local law enforcement agency regarding a tax covered by the agreement. The person also could not currently be the subject of a civil action or a criminal prosecution involving any covered tax.

In addition, the person would have to agree to do the following:

- -- Register, file returns, and pay all taxes due in accordance with all applicable laws of this State for all taxes administered under the Act for all periods after the lookback period.
- -- Pay all taxes due for each tax covered under the agreement for the lookback period, plus statutory interest as stated in the Act, within the time and in the manner specified in the agreement.
- -- File returns and worksheets for the lookback period as specified in the agreement.

The person also would have to agree to all other terms and conditions specified by the Commissioner or his or her authorized representative, on behalf of the Treasury Department, in the agreement.

If a nonfiler, before the bill's effective date, received a letter of inquiry (whether a final letter or otherwise) requesting information, the nonfiler would qualify for a voluntary disclosure agreement if the person sent a written request to the Department to enter into an agreement within 90 days after the bill's enactment.

<u>Relief</u>

If a person satisfied all of the eligibility requirements, the Department could enter into a voluntary disclosure agreement providing the relief described below.

The Department could not assess any tax, delinquency for a tax, penalty, or interest covered under the agreement for any period before the lookback period identified in the agreement. (The bill would make an exception to the current provision that the Commissioner or a Department employee may not compromise or reduce the taxes due to or claimed by the State or unpaid revenue or amounts due to any department, institution, or agency of State government.) The Department also could not assess any applicable discretionary or nondiscretionary penalties for the lookback period.

The Department would have to provide complete confidentiality of the agreement, as well as enter into an agreement not to disclose, in accordance with Section 28(1)(f), any of the terms or conditions of the agreement to any tax authorities of any state or governmental authority or to any person except as required by exchange of information agreements authorized by Section 28(1)(f), including the International Fuel Tax Agreement. The Department could not exchange information obtained under the bill with other states regarding the person unless specifically requested by other states. (Section 28(1)(f) generally prohibits Department employees and authorized representatives from divulging information obtained in connection with the administration of a tax. The Commissioner may enter into reciprocal agreements with other departments, the U.S. Department of Treasury, local units of government of this State, or taxing officials of other states for the enforcement, collection, and exchange of data.)

The bill also would prohibit the Treasury Department from bringing a criminal action against a person for failure to report or to remit any tax covered by the agreement before or during the lookback period if the facts established by the Department were not materially different from the facts disclosed by the person.

A voluntary disclosure agreement would be effective when signed by the person subject to it, or the person's lawful representative, and returned to the Department within the time period specified in the agreement. The Department could provide only the relief specified in the agreement. Any verbal or written communication by the Department before the agreement's effective date would not afford any penalty waiver, limited lookback period, or other benefit otherwise available under the bill.

Other Provisions

An applicant's material misrepresentation of fact relating to the applicant's current activity in this State would render an agreement null and void and of no effect. A change in a person's activities or operations after an agreement's effective date would not be a material misrepresentation of fact and could not affect the agreement's validity.

The Department could audit any of the taxes covered by an agreement within the lookback period or in any prior period if, in the Department's opinion, an audit of a prior period were necessary to determine the person's tax liability for the tax periods within the lookback period or to determine another person's tax liability.

The bill specifies that nothing in it could be interpreted to allow unjust enrichment. Any tax collected or withheld from another person by an applicant would have to be remitted to the Department without respect to whether it was collected during or before the lookback period. ("Unjust enrichment" would include the withholding of income tax and the collection of any other tax administered by the Act that had not been remitted to the Department.)

MCL 205.28 et al. (S.B. 872)
208.52 (S.B. 890)

BACKGROUND

The Department of Treasury cited the following three Michigan Court of Appeals cases as invalidating the Department's reliance on Federal law with respect to nexus: *The Gillette Co.* v *Michigan Department of Treasury*, 198 Mich App 303 (1993); *Guardian Industries Corp.* v *Michigan Department of Treasury*, 198 Mich App 363 (1993); and *Magnetek Controls, Inc.* v *Michigan Department of Treasury* (221 Mich App 400). Each of these cases involved a multistate firm's liability under the SBT Act. In *Gillette*, the firm was headquartered out of State, while the taxpayers in *Guardian Industries* and *Magnetek Controls* were based in Michigan. In deciding the nexus issue in each case, the Court examined such factors as the presence and size of a sales staff, ownership of promotional and replacement merchandise located in a state, and the level of sales generated within a state. These decisions are described briefly below.

In *The Gillette Co.* v *Michigan Department of Treasury*, Gillette challenged the Department's jurisdiction to assess the SBT against it for the solicitation of orders in Michigan. A Delaware company with its base of operations in Boston, Gillette based its argument on a Federal statute, PL 86-272 (15 USC 381). That statute generally provides that a state may not impose a net income tax on the income derived within that state by any person from interstate commerce if the person's only business activities within the state are solicitation of orders that meet certain criteria (e.g., for sales of tangible personal property that are filled by shipment from a point outside the state). The Court of Appeals concluded that the SBT was not a tax imposed on or measured by net income, and PL 86-272 did not apply.

The Court then considered whether the imposition of the SBT on Gillette was permissible under the due process and commerce clauses of the U.S. Constitution. Since the nexus standards of the two clauses are not identical, a tax that withstands a due process challenge might not survive a commerce clause challenge.

The Court stated that, to meet the requirements of due process, there must be some definite link between the state and the person, property, or transaction it seeks to tax, and the income must be rationally related to values connected with the taxing state. The Court held that the due process clause did not bar the assessment of the SBT on Gillette.

The commerce clause gives Congress the power to regulate commerce among the states. A tax will withstand a commerce clause challenge if it 1) is applied to an activity with a substantial nexus within the taxing state; 2) is fairly apportioned; 3) does not discriminate against interstate commerce; and 4) is fairly related to the services provided by the state (*Complete Auto Transit, Inc.* v *Brady*, 430 US 274 (1977)). In the *Gillette* case, the Court of Appeals found that the SBT was applied to an activity having a substantial nexus in Michigan, based upon the presence of Gillette's sales staff in Michigan, and their activities and use of equipment in this State.

In *Guardian Industries Corp.* v *Department of Treasury*, the corporation's principal place of business was in Michigan. Since it solicited sales in various other states, Guardian claimed that a portion of its sales was subject to the tax jurisdiction of the other states. The Department argued, however, that PL 86-272 and the U.S. Constitution would be violated if the other states attempted to tax Guardian based merely upon its solicitation of sales.

The Court of Appeals held that PL 86-272 did not provide the minimum nexus standard appropriate for determining whether a foreign state's taxation of a Michigan taxpayer would violate the due process or commerce clause. In regard to the constitutional challenge, the Court determined that Guardian had failed to meet the burden of showing that the substantial nexus requirement was satisfied, because the record did not establish that it had a physical presence in each of the target states.

Magnetek Controls, Inc. v *Michigan Department of Treasury* was decided by the Court of Appeals on February 7, 1997. This taxpayer's offices and factory were located in Michigan, and it was assessed SBT liability for sales made into a number of other states. The Court of Claims had determined that the commerce clause would not prevent the other states from imposing taxes on Magnetek and, therefore, the sales made into those states could not be attributed to Michigan for SBT purposes. The Court of Appeals agreed, and stated, "...tax obligations may be imposed, consistent with the Commerce Clause, on taxpayers with 'demonstrably more than a "slightest presence"' in a state, and this requirement can be satisfied by 'the conduct of economic activities in the taxing State performed by the vendor's personnel or on its behalf.'"

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

As a result of the Michigan Court of Appeals rulings in *Guardian Industries*, *Gillette*, and *Magnetek Controls*, the Department of Treasury reports that it can no longer rely on its previous standards for determining whether nexus exists for purposes of calculating a multistate firm's single business tax. Therefore, the Department has issued specific new nexus standards under RAB 98-1. Since these standards are retroactive through 1989, there is concern that some firms might incur substantial penalties for single business taxes they owe for past years. By eliminating the penalties that otherwise may be assessed for late payment of taxes, Senate Bill 872 (S-1) would help encourage these taxpayers to come forward and disclose their prior-year tax liabilities under the new standards. In addition, in some cases, the number of back years for which businesses are liable under the new standards would be limited. By giving businesses an incentive to clear up their tax liabilities for past years, the bill also would save the Department audit resources. At the same time, by eliminating the throwback rule, Senate Bill 890 would make the SBT Act consistent with the new nexus standards.

Legislative Analyst: S. Lowe

FISCAL IMPACT

The Michigan Court of Appeals rulings will force State government to refund, in FY 1997-98, $27 million of single business tax payments made in prior years.

According to the Department of Treasury, the new nexus standards, along with the voluntary disclosure procedures proposed in Senate Bill 872 (S-1), would increase single business tax revenue by an estimated $20 million, and eliminating the throwback rule, as proposed in Senate Bill 890, would decrease single business tax revenue by an estimated $20 million. Therefore, it is estimated that together, the bills, which are tie-barred, would not generate any net change in single business tax revenue.

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