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Michigan Supreme Court Delivers Good Tax News for Michigan Businesses, Bad News for Out-of-State Companies

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On July 31, 2023, a divided Michigan Supreme Court in *Vectren Infrastructure Services v. Michigan Treasury* issued an important decision in favor of the state, ruling that an out-of-state taxpayer could not reduce its tax by taking into consideration the location of its business assets when paying tax on the sale of that business in Michigan.

The decision is favorable to Michigan-based companies because it confirms that the proceeds from selling a business can never be considered in determining where the gain is taxed. This was detrimental to Indiana-headquartered Vectren because its business assets were entirely outside of Michigan, yet the gain from their sale was taxed based on the other revenues that Vectren generated in Michigan.

This was the second time the Michigan Supreme Court reviewed the decision of the Court of Appeals after it had ruled that the taxpayer was entitled to alternative apportionment for Michigan business tax purposes. The Michigan Department of Treasury rarely, if ever, grants alternative apportionment, and the case was therefore closely watched and very important to Michigan taxpayers.

Michigan calculates business taxes for companies operating in more than one state using a simple formula: Michigan sales divided by total sales, multiplied by total income. The taxpayer in this case was a Minnesota-based pipeline construction and repair company that operated in multiple states and had historically done only about 1% of its business in Michigan. It had roughly 600 employees and 1,200 pieces of construction equipment, and none were based in Michigan.

In 2010, it secured a large contract to clean up an oil spill in the Kalamazoo River after an Enbridge pipeline leaked, causing a major environmental event. Coincidentally, it also sold the company in March of 2011, generating a $51 million gain in addition to its operating income of $4 million. At that point in the year, 70% of its revenues had been generated from that one huge Michigan project. In its original return, Vectren had included the proceeds of the sale of its business assets in the denominator of its single sales apportionment factor, reducing its Michigan sales factor to about 14% from 70% and its tax from $2.3 million to $400,000. On audit, Treasury excluded those proceeds from the factor and assessed tax, interest and penalty of $3.4 million. The taxpayer appealed.

The Court of Appeals agreed with Treasury's argument that the statute does not allow the inclusion of those proceeds in the factor. However, the Court of Appeals concluded that the statutory formula was constitutionally defective as applied to these facts and remanded the case back to the parties to attempt to resolve that defect. The Michigan Supreme Court then ordered the parties to address both the statutory and constitutional standards for alternative apportionment and whether the remand violates the Department of Treasury's exclusive authority to approve alternative methods of apportionment.

In the Michigan Supreme Court decision, the majority took a very narrow view of the standard for constitutional distortion. It held that the company must prove that the income was earned in the course of activities unrelated to the unitary business engaged in within the state to justify alternative apportionment. Since the business assets that generated the large gain were related to the business conducted in Michigan, it found that the statutory formula was applicable. The majority was not moved by the fact that Michigan was taxing 70% of the gain generated by the out-of-

state taxpayer that had no permanent operations in the state but merely a large contract in Michigan in the year of the sale, and the fact that the gain represented the value of the entire business and not merely the profits from the business conducted in the state. It also rejected the argument advanced by the taxpayer that it was entitled to "factor representation" – that the apportionment factor should fairly reflect the activities that gave rise to the income being taxed.

The three dissenting justices would have ruled in favor of the taxpayer and invalidated what they called a "grossly disproportionate money grab" which taxed economic values unrelated to the activity in the state. They felt that the case illustrates the potential unconstitutionality of a single factor sales formula, especially one that considers only sales of inventory and other sales in the ordinary course of business while including all income in the tax base. They noted that a single factor sales formula can be constitutional, as the U.S. Supreme Court concluded in its landmark 1978 decision in *Moorman v Bair*, but that decision does not mean that such a formula is constitutional in all cases. They also noted that the fact that the taxpayer's sales in Michigan returned to their historic norm of about 1% of total sales after the aberration of 70% in the three-month short period preceding the sale showed a clear case of distortion.

While it is unclear whether the taxpayer is prepared to continue the fight and seek appeal to the U.S. Supreme Court, the facts do present an interesting case regarding the constitutionality of a single factor sales formula that ignores the location of a taxpayer's property and payroll. Barring further review, which is unlikely even if pursued, the decision represents good news for Michigan-based companies operating in a national market, because it ensures that in similar circumstances the proceeds of the sale of a Michigan business cannot be taken into consideration in the calculation of their Michigan corporate tax.

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