

**SENATE FISCAL AGENCY
 MEMORANDUM**

DATE: August 4, 2016
TO: Members of the Senate
FROM: Suzanne Lowe, Associate Director
 David Zin, Chief Economist
RE: *IBM v. Department of Treasury*

This memorandum discusses the recent Michigan Court of Appeals decision in *International Business Machines, Corp. v. Department of Treasury*, which concerns the Michigan Business Tax liability of IBM for the 2008 tax year. The issue in the case was whether IBM was allowed to calculate its taxes using the three-factor apportionment formula under the Multistate Tax Compact or was required to use the single-factor apportionment formula under the Michigan Business Tax (MBT) Act. Previously, the Michigan Supreme Court held that IBM could use the three-factor formula (which produced a lower tax liability), and remanded the case to the Court of Claims, where it had originated. The Supreme Court ordered the Court of Claims to enter judgment in favor of IBM, but the Court of Claims entered an order in favor of the Department of Treasury. This led to the recent decision of the Court of Appeals, which reversed the Court of Claims and remanded for entry of judgment in favor of IBM.

It should be noted that this decision pertains only to the MBT liability of IBM and no other taxpayer, and it only involves IBM's tax liability for the 2008 tax year. As discussed below, legislation enacted in 2011 removed taxpayers' option to calculate their MBT liability under the Multistate Tax Compact's three-factor apportionment formula, and legislation enacted in 2014 repealed the Compact provisions retroactive to January 1, 2008 (the effective date of the MBT Act).

If the State does not appeal the Court of Appeals decision to the Michigan Supreme Court, or does appeal and the Supreme Court does not find in the State's favor, the decision will reduce State General Fund revenue by \$6.0 million. Because the judgment will be known, under the State's accrual system of accounting, the \$6.0 million impact will be booked against fiscal year 2015-16 revenue, even if the check is ultimately issued later.

History of Related Legislation

Public Act 343 of 1969 enacted the provisions of the Multistate Tax Compact, effective July 1, 1970. The Compact initially was drafted out of concerns of state sovereignty in reaction to the introduction of Federal legislation that sought to regulate various areas of state taxation. Under the Compact's "election provision", a taxpayer with activity in multiple states may choose to allocate or apportion its income according to the formula in the Compact, which computes three separate factors--payroll, property, and sales--or according to the apportionment formula of the taxpayer's state (assuming the state is a party to the Compact).

Public Act 36 of 2007 enacted the Michigan Business Tax Act, effective January 1, 2008. The MBT Act requires a multistate taxpayer to apportion its income using only a sales factor.

A package of legislation enacted in 2011 created the Corporate Income Tax and repealed the MBT Act for most taxpayers. (Taxpayers that continue to file MBT returns do so in order to claim certain credits. The Act will be fully repealed when the last of these credits has been claimed.) This legislation also included Public Act 40 of 2011, which amended the Multistate Tax Compact provisions to remove the option of using the Compact's three-factor apportionment formula. The amendment applied to all tax years beginning on or after January 1, 2011.

Public Act 282 of 2014 repealed Public Act 343 of 1969 (the Multistate Tax Compact provisions) retroactive to January 1, 2008. Public Act 282 also contained language indicating that the repeal of Public Act 343 "is to express the intent of the legislature" that Section 301 of the MBT Act (which contains the requirement to use the sales-factor apportionment formula) was to remove the option of electing to use the three-factor formula under the Compact.

Arguably, Public Act 40 of 2011 had created a three-year window, for tax years 2008, 2009, and 2010, when both the MBT sales-factor apportionment formula and the Compact's three-factor formula were available to taxpayers. Since Public Act 282 was retroactive to January 1, 2008, however, it effectively eliminated that three-year window. As discussed below, this issue was litigated in *Gillette Commercial Operations North America & Subsidiaries v. Department of Treasury*. The Court of Appeals held that Public Act 282 was constitutional and taxpayers were not entitled to use the Compact's formula for the affected tax years. Unlike the disputes of taxpayers that were pending when Public Act 282 was enacted, *IBM v. Treasury* had already been decided by the Supreme Court.

The *IBM v. Treasury* Litigation

In December 2009, IBM filed its MBT return for the 2008 tax year, which indicated IBM's election to use the three-factor apportionment formula provided in the Multistate Tax Compact. Using this calculation, IBM sought a refund of \$5,955,218. The Department of Treasury determined that IBM could not use the Compact formula and was entitled to a refund of only \$1,253,609, when calculated under the MBT sales-factor formula. After IBM filed a challenge in the Court of Claims, the Court granted summary disposition in favor of the Department and determined that the MBT Act mandated use of its apportionment formula.

In an unpublished opinion, the Court of Appeals affirmed the order of the Court of Claims. The Court of Appeals determined that there was a conflict between the MBT Act and the Compact, and concluded that the Legislature had implicitly repealed the Compact's election provision when it enacted the MBT Act.

On July 14, 2014, the Michigan Supreme Court reversed the Court of Appeals, holding that IBM was entitled to use the Compact's three-factor apportionment formula for its 2008 taxes, including the portion of its tax base subject to the modified gross receipts tax. The Supreme Court stated that the Court of Appeals "erred by holding otherwise on the basis of its erroneous conclusion that the Legislature had repealed the Compact's election provision by implication" when it enacted the MBT Act.

The Supreme Court reversed the Court of Appeals judgment in favor of the Department, reversed the Court of Claims order granting summary disposition in favor of the Department, and remanded to the Court of Claims for entry of an order granting summary disposition in favor of IBM. In November 2014, the Supreme Court denied the Department's motion for rehearing.

On remand, the Court of Claims initially entered judgment in favor of IBM, as directed by the Supreme Court. Subsequently, however, it granted the Department's motion for reconsideration, determining that Public Act 282 of 2014 (which repealed the Compact provisions retroactive to January 1, 2008) represented an "intervening change of law".

On July 21, 2016, the Court of Appeals reversed the order of the Court of Claims and remanded for entry of judgment in favor of IBM consistent with the Supreme Court's 2014 decision. According to the Court of Appeals, the Court of Claims had no discretion or authority to rule in favor of the Department, but was required to strictly comply with the Supreme Court's remand order. As to the Department's position that the Court of Claims should have been able to examine the issue of IBM's 2008 taxes under Public Act 282 of 2014, the Court of Appeals said that this position was untenable and stated, "[I]t is well-established that 'the Legislature may not reverse a judicial decision.' ... If 2014 PA 282 is specifically applied in order to ascertain the apportionment formula applicable to IBM with respect to its 2008 business taxes, it would effectively result in the impermissible legislative reversal of *Int'l Business Machines*." The Court also pointed out that the Supreme Court was fully aware of Public Act 282 when it denied the Department's motion for rehearing.

Further, the Court of Appeals discussed its September 2015 opinion in *Gillette Commercial Operations North America & Subsidiaries v. Department of Treasury*. The *Gillette* opinion decided appeals brought by a number of taxpayers that are incorporated outside of Michigan but do business in the State. The taxpayers had filed suit in the Court of Claims seeking refunds due under the Multistate Tax Compact that had been refused by the Department of Treasury on the ground that the only apportionment method available was the one established by the MBT Act. The taxpayers challenged the constitutionality of Public Act 282 of 2014 and its retroactive repeal of the Compact's provisions. The trial court rejected each of the constitutional challenges, dismissed the complaints, and held in favor of the Department. The Court of Appeals affirmed, finding that Public Act 282 was constitutionally sound. On June 24, 2016, the Michigan Supreme Court denied leave to appeal.

In *IBM v. Treasury*, the Court of Appeals said that the *Gillette* decision could not overrule or reverse the Supreme Court's earlier opinion in *IBM* and the resolution of the specific tax issues addressed in the opinion. Unlike the disputes in *Gillette*, which were pending at the time Public Act 282 was enacted, *IBM v. Treasury* had already been decided. The Court recognized that the Legislature was free to change the law in response to that decision, so taxes *other than* those addressed in the *IBM* opinion were subject to Public Act 282.

As noted above, the Court of Appeals in *IBM v. Treasury* reversed the order of the Court of Claims and remanded for entry of judgment in favor of IBM. The Court of Appeals also awarded taxable costs to IBM.

At this time, it is not known whether the Department of Treasury will appeal to the Michigan Supreme Court. The Department has 42 days after the date of the Court of Appeals opinion to file an application for leave to appeal. When that period expires, the Court of Claims will be notified either that it needs to enter a judgment in the case or that the case is on application with the Supreme Court. In the meantime, the Court of Claims is waiting for the appeal period to expire.

Fiscal Impact of *IBM v. Department of Treasury*

While the Court of Appeals decision will likely reduce fiscal year (FY) 2015-16 State General Fund revenue by approximately \$6.0 million, Public Act (PA) 282 of 2014 and the *Gillette* decision prevented the *IBM* decision from having a much larger impact on State revenue. According to the Department of Treasury, PA 282 of 2014 prevented the State from paying approximately \$1.1 billion in refunds, a total that would have represented roughly 11% of FY 2014-15 ongoing General Fund revenue. The refunds prevented by PA 282 of 2014 represent roughly the equivalent of what the State spent on higher education, or more than the State spent out of the General Fund to operate the Departments of Agriculture and Rural Development, Attorney General, Civil Rights, Education, Military and Veteran Affairs, State Police, and Treasury (including debt service), and the judiciary, in FY 2014-15. In contrast, the \$6.0 million liability from the recent Court of Appeals decision represents approximately 0.06% of ongoing General Fund revenue in FY 2015-16.

If you have questions about this memorandum, please contact either author at 3-2768. Questions concerning fiscal issues should be directed to David Zin.

cc: Ellen Jeffries, Director