

A POLICY ANALYSIS OF MICHIGAN'S MISLABELED GROSS RECEIPTS TAX

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On January 1, 2008, the State of Michigan implemented a new tax, labeled a modified gross receipts tax (MGRT).¹ The label is misleading. The tax is not on gross receipts but rather on gross receipts reduced by “purchases from other firms,”² defined generally to include inventory purchased during the taxable year, capital purchases, and material and

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1. See MICH. COMP. LAWS ANN. §§ 208.1101-.1609 (West Supp. 2007).

2. See MICH. COMP. LAWS ANN. § 208.1203 (West Supp. 2007).

supplies.³ In some respects, the tax resembles a value-added tax (VAT), although it has important features not found in a traditional VAT or in any known variation of that tax. The purpose of the MGRT, other than to raise revenue, is unclear on its face and is not clarified by the legislative history, which is virtually nonexistent.

In this article, we describe this new tax, classify it as best we can within traditional tax taxonomy, and speculate about its effects on Michigan taxpayers and on the Michigan economy. Section I, by way of introduction, summarizes the tax reform efforts that led to the adoption of the gross receipts tax. Section II discusses the problems of classifying the tax, comparing it to a common gross receipts tax and to a tax on value added. Section III begins with an overview of the salient features of the MGRT and then discusses in greater detail three important features of the tax, namely its nexus rules, its apportionment rules, and its unitary business rules. We speculate about the impact of the tax on Michigan and Michigan taxpayers in the conclusion.

I. INTRODUCTION

The Michigan Legislature enacted the Michigan Business Tax (MBT) on June 29, 2007.⁴ The new tax regime, after amendments adopted on December 1, 2007,⁵ became effective on January 1, 2008.⁶ The amendments, *inter alia*, imposed a surcharge of around 22% on the various components of the MBT.⁷ That surcharge replaces the revenue that had been expected from a 6% sales/use tax on services, which was repealed at the same time.⁸

3. See MICH. COMP. LAWS ANN. § 208.1113(6) (West Supp. 2007).

4. See 2007 Mich. Pub. Acts 36.

5. See 2007 Mich. Pub. Acts 145.

6. See MICH. COMP. LAWS ANN. § 208.1101 (West Supp. 2007).

7. See MICH. COMP. LAWS ANN. § 208.1281 (West Supp. 2007).

8. The services tax was adopted on October 1, 2007 by 2007 Mich. Pub. Acts 93 and repealed, retroactively, on December 10, 2007 by 2007 Mich. Pub. Acts 148, thus suffering the same fate as Florida's attempt to extend its sales tax to services. See James Francis, *The Florida Sales Tax on Services: What Really Went Wrong?*, in THE UNFINISHED AGENDA FOR STATE TAX REFORM 129 (Steven D. Gold ed., 1988). Opinion writers treated Michigan's ill-fated services tax as a joke, due to many odd features of its base. See, e.g., Chris Christoff, *Details of Service Tax Raise Questions; Oddities Confuse Public, Lawmakers*, DETROIT FREE PRESS, Oct. 5, 2007, at 6. For example, it taxed personal fitness trainer services, MICH. COMP. LAWS ANN. § 205.93d(1)(i)(xxv) (West Supp. 2007), and skiing services, MICH. COMP. LAWS ANN. § 205.93d(1)(l) (West Supp. 2007), but not golf services. Many businesses opposed it because the tax applied to a host of business inputs, which should be excluded from the base of a normative sales tax. See Chris Christoff, *Tax Fight Pits Big Business vs. Small: Large Firms Get Large Savings from Change*, DETROIT FREE PRESS, Nov. 10, 2007, at 1 ("Some of Michigan's biggest and most influential companies begged the Legislature this week to raise a new business tax that takes effect Jan. 1. But first, they asked, please kill the 6% tax on services set to begin Dec. 1."). For a discussion of a normative sales tax, see RICHARD D. POMP & OLIVER OLDMAN, STATE AND LOCAL TAXATION ch. 6 (5th ed. 2005).

The MBT consists of four separate taxes:⁹ (1) Business Income Tax;¹⁰ (2) Modified Gross Receipts Tax (MGRT);¹¹ (3) Gross Insurance Premiums Tax;¹² and (4) Bank Capital Tax on Financial Institutions.¹³ The first two are general provisions; the latter two are specific to insurance and financial institutions.¹⁴ Only the MGRT is addressed in any detail in this Article.

The four taxes contained in the MBT replace the revenue previously obtained from the Michigan Single Business Tax (SBT), which was repealed as of December 31, 2007.¹⁵ The SBT was adopted in 1976.¹⁶ It replaced a corporate income tax,¹⁷ a franchise tax, an intangibles tax, a bank excise tax, a personal property tax on inventory, and other less significant taxes.¹⁸ The SBT was amended many times in response to various criticisms and political pressures. By the time of its demise, it had so many *ad hoc* features that it was not recognizable within the

9. The MBT, with its four taxes, replaces the Single Business Tax, which ironically was enacted to replace the multiple taxes that previously existed. The MBT is quickly becoming known as the "Multiple Business Tax." Patrick R. Van Tiflin, *New, Five-Part Michigan Business Tax Replaces SBT, Leaving Many Questions Unanswered for Certain Taxpayer*, 14 TAX MGM'T MULTISTATE TAX REP. 450 (2007) [hereinafter *Five-Part Michigan*].

10. The tax is imposed at the basic rate of 4.95% on the business income tax base after allocation or apportionment. MICH. COMP. LAWS ANN. § 208.1201 (West Supp. 2007). The tax so imposed is subject to a 21.99% surcharge. MICH. COMP. LAWS ANN. § 208.1281 (West Supp. 2007).

11. The tax is imposed at a nearly 1% rate. *See infra* text accompanying notes 109-113.

12. The tax is imposed at the greater of 1.25% on gross direct premiums written on property or risk located or residing in Michigan, MICH. COMP. LAWS ANN. § 208.1235(2) (West Supp. 2007), or the tax calculated under section 476a of the insurance code, MICH. COMP. LAWS ANN. § 208.1243(1)(a) (West Supp. 2007). The tax so calculated is subject to an additional surcharge.

13. The tax is imposed at the basic rate of 0.235% on the tax base of a financial institution after allocation or apportionment to Michigan and is subject to a surcharge. MICH. COMP. LAWS ANN. § 208.1263 (West Supp. 2007). The tax base is average net capital. MICH. COMP. LAWS ANN. §§ 208.1263-.1265 (West Supp. 2007).

14. For 2008, 2009, and 2010, the MBT provides that if the revenue collected exceeds certain baseline amounts, 60% of the excess will be refunded to taxpayers making net cash payments and the other 40% will be deposited in the countercyclical budget and economic stabilization fund. MICH. COMP. LAWS ANN. § 208.1601 (West Supp. 2007).

15. 2006 Mich. Pub. Acts 325 or MICH. COMP. LAWS ANN. § 208.151 (West Supp. 2007).

16. *See* MICH. COMP. LAWS ANN. § 208.1 (West 2003) (repealed for tax years beginning after Dec. 31, 2007).

17. The corporate income tax was adopted in 1967. Previously, Michigan enacted a business activities tax, which was in effect between 1953 and 1967. The business activities tax was a modified gross receipts tax properly classified as a VAT. Patrick R. Van Tiflin, *Under Assault Since its Inception, Michigan's SBT is Sure to be Repealed, But What Will Take its Place?*, 13 TAX MGM'T MULTISTATE TAX REP. 310 (2006) [hereinafter *Under Assault*].

18. *See* Jack E. Mitchell, *Taxes Repealed and Amended*, 22 WAYNE L. REV. 1017 (1976).

traditional taxonomy of tax regimes. It apparently had lost whatever charm it may initially have possessed.

Stripped of its many ornaments, the core of the SBT was intended to be an addition-method value-added tax.¹⁹ Such taxes are not common. The one remaining state example is New Hampshire's Business Enterprise Tax.²⁰ Another example is the Hall-Rabushka flat-tax, proposed as a replacement for the Federal corporate and individual income taxes, although for political reasons its supporters often misdescribe it as a type of income tax.²¹ In an additive-method VAT, the tax base is computed by adding up all business inputs, including profits, wages paid, rent, and interest paid.²²

An addition-method VAT is typically an origin-based tax. It is imposed on value added within the taxing jurisdiction, without regard for where the goods and services produced are actually consumed. It typically does not apply to value added attributable to imports into the taxing jurisdiction, but it does apply to value added attributable to exports out of the tax jurisdiction.²³ Such a tax could have the effect of making exports more expensive and giving a tax preference to imports—results that few taxing jurisdictions would favor.²⁴

One major difference, however, between the SBT and a paradigmatic addition-method VAT was that the SBT was apportioned between Michigan and the rest of the world using an apportionment formula. Initially, the apportionment formula was the three-factor formula (property, payroll, and sales) used by the Uniform Division of Income for Tax Purposes Act (UDITPA).²⁵ The effect of this formula generally was to apportion one third of the tax base to the place of production and two thirds to the place of sale. Consequently, the formula caused a firm importing into Michigan to be taxed significantly less heavily than a firm

19. ALAN SCHENK & OLIVER OLDMAN, *VALUE ADDED TAX: A COMPARATIVE APPROACH* 43 (Cambridge University Press 2007).

20. *Id.* at 395. At the national level, the only example cited of an addition-method VAT is the Israeli tax on financial institutions and insurance companies; although that tax is not administered as part of the Israeli VAT system. *Id.* at 43.

21. *Id.* at 449.

22. *Id.* at 42-43.

23. In the context of the discussion in the text, "imports" refers to goods brought into Michigan from other jurisdictions, including other states and foreign countries. "Exports" refers to goods shipped from Michigan to other jurisdictions, including other states and foreign countries.

24. In defending the Hall-Rabuska flat tax against the charge that it improperly burdens exports and favors imports, some commentators have suggested that currency adjustments might offset these otherwise adverse effects. For a more in-depth discussion, see Michael J. McIntyre, *International Aspects of Kemp Commission Report*, 70 *TAX NOTES* 607-09 (Jan. 29, 1996). No one suggests that the adverse effects of an origin-based tax imposed by a state would be offset by currency adjustments.

25. See *MICH. COMP. LAWS ANN.* §§ 208.45-.46, 208.49, 208.51 (West 2003). The SBT, with its three-factor formula, was upheld against constitutional challenge in *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358 (1991).

exporting from Michigan, a result that made little sense if the SBT was intended to be passed on to consumers, as generally would be expected with a VAT.²⁶ Beginning in 1991, the weight of the sales factor was increased substantially. It was scheduled to reach 95% for tax years beginning after December 31, 2007.²⁷ The result of the shift in weighting was to greatly reduce the tax on firms manufacturing entirely in Michigan for export whereas the tax on firms manufacturing outside the State for sale in Michigan was increased.²⁸ This change is consistent with the goal of a tax on consumption.

One of the goals of the Michigan Legislature in adopting the SBT was to provide a stable source of revenue.²⁹ The Michigan automobile industry was subject to large swings in profitability. Under a corporate income tax, those swings typically would cause the State to suffer a significant reduction in tax revenues at a time when the demands for government services from unemployed workers were likely to be increasing significantly. In this respect, the SBT was a grand success.

Whatever the technical merits of the SBT, it became such a political liability that political leaders in both parties were unwilling to defend it. The SBT was rarely seen as a value-added tax by the businesses collecting it or by the legislators asked to revise it. Instead of being viewed as a tax collected by business and passed on to consumers, it was viewed as a peculiar and unfair tax on business. Although wages are properly included in the base of a VAT, their inclusion in the base of the SBT was widely criticized. Critics claimed that this feature of the tax

26. If a state had a monopoly position with respect to its exports, then it might maximize its own position, at the expense of its sister states, by exporting its tax to consumers in other states or foreign countries. Curiously, the SBT was adopted in 1976, around the time that General Motors was losing its role as price leader in the automobile industry. Whatever the rationale for the treatment of exports, we cannot imagine even a selfish reason for exempting imports, which will compete with goods made in Michigan.

27. See MICH. COMP. LAWS ANN. § 208.45a (West Supp. 2007) (repealed for tax years beginning after Dec. 31, 2007).

28. The shift to a formula that heavily weighted sales occurred at a time when some states were moving to a sales-only formula for their corporate income tax. Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes—A Boon to Economic Development or a Costly Giveaway?*, CENTER ON BUDGET AND POLICY PRIORITIES (Sept. 1, 2005), available at <http://www.cbpp.org/3-27-01sfp.pdf> (last visited June 24, 2008). The argument for use of a sales-only formula for corporate income tax purposes has almost nothing to do with the arguments for its use in an addition-method VAT. In the latter case, the argument is that the state, as a normative matter, should not be taxing exports and should be taxing imports. That argument is compelling if the point of the tax is to tax consumption in the state—the usual goal of a VAT. In the former case, the argument is that a state can get some competitive advantage over other states by departing from the UDITPA formula. Whether a competitive advantage is actually obtained is unclear. See Michael J. McIntyre, *Thoughts on the Future of the State Corporate Income Tax*, 25 STATE TAX NOTES 931-47 (2002); see also Mazerov, *supra* note 28.

29. James W. Haughey, *The Economic Logic of the Single Business Tax*, 22 WAYNE L. REV. 1018 (1976).

discouraged employment.³⁰ In addition, unlike an income tax, but like a sales tax, the SBT was collected, sometimes in substantial amounts, by businesses operating at a loss. Many businesses felt this result was unfair. Again, a normative VAT ought to be paid whether or not the business collecting the tax is profitable. In the end, business groups, state legislators, and, eventually the voting public, came to view the SBT as “a negative influence on Michigan’s attempt to participate in the good economic times being enjoyed elsewhere in the country.”³¹

We are not suggesting that everyone was wrong in his or her criticisms of the SBT. Whether it actually was passed on to consumers through higher prices is a difficult (perhaps unknowable) empirical question, whose answer might vary from firm-to-firm, and from product-to-product, and we have made no effort to make such an assessment. Certainly all of the special-interest modifications of the SBT made it less uniform in its application, and a non-uniform VAT is more difficult to pass on than one that applies equally to all goods and services. At a minimum, we would readily concede that the SBT was ripe for a major overhaul.

The SBT was repealed without a plan for replacing the lost revenue. Michigan already had made major budgetary cuts in recent years, and it had a significant structural deficit even before repealing the SBT.³² Consequently, the Governor was unwilling to close the budget gap through additional budget cuts.³³ Legislators apparently concluded that the gap had to be closed through replacement taxes, and that these taxes had to be perceived by the public as taxes on business.

The package of tax changes flying under the MBT label included the four taxes mentioned above plus a combination of property tax cuts³⁴ and tax incentives intended to foster job creation.³⁵ The property tax cuts and the tax incentives were intended to make Michigan more attractive for

30. The effect of a state’s tax structure on economic development is exceedingly complicated. See Robert G. Lynch, *Weaknesses in the Common Arguments for State and Local Tax Cuts and Incentives*, 32 STATE TAX NOTES 597 (2004); Robert G. Lynch, *The Effects of State and Local Taxes and Public Services on Economic Development*, 32 STATE TAX NOTES 767 (2004).

31. *Under Assault*, *supra* note 17, at 309.

32. Citizens Research Council of Michigan, *Michigan’s Budget Crisis and the Prospects for the Future*, STATE BUDGET NOTES (Mar. 2006).

33. Jennifer M. Granholm, Radio Address, Dec. 1, 2006, available at: http://michigan.gov/documents/gov/Radio_Address_MBT_12.1.06_TEXT_179631_7.pdf (last visited June 24, 2008).

34. The MBT provides a 24 mill reduction in the rate of personal property taxation on industrial personal property, a 12 mill reduction for commercial personal property, a refundable 35% credit against the MBT for personal property taxes paid on industrial personal property (replacing the 15% credit in the SBT), a refundable 23% credit for personal property taxes paid by telephone companies in 2008, reduced to 13.5% in subsequent years, and a 10% refundable credit for personal property taxes on natural gas pipelines. MICH. COMP. LAWS ANN. § 208.1413(1) (West Supp. 2007).

35. See, e.g., MICH. COMP. LAWS ANN. §§ 208.1403-1417 (West Supp. 2007).

business investment. The new business income tax will make the Michigan tax system somewhat more vulnerable to recessions in the automobile industry. The tax, however, is a familiar one, used by almost all of the states, and the rate is moderate.³⁶ Although a comprehensive review of the income tax is outside the scope of this article, we are pleased to see that it does have one excellent design feature, namely, a requirement for members of a unitary business to file a combined report.³⁷ However, it also lacks a common and desirable feature—a throwback rule.³⁸ If the business income tax is not passed on to consumers through higher prices, it should somewhat help reduce the overall regressiveness of the Michigan tax system.³⁹ Given the widespread criticism of the SBT for its failure to take income into account in assessing taxes, an income-based component to the replacement package probably was inevitable.

The MGRT offers a relatively stable revenue source because, like the SBT, it is mostly a tax on value added, which is a more stable tax base than income. It is designed as a destination tax, thereby avoiding the heavier taxation of firms producing in Michigan for export than of firms producing outside of Michigan for sale in the State, which occurred under the SBT before the shift in the weighting of the sales factor. Although the MGRT implicitly includes wages in its base, that fact is far less obvious than it was under the SBT, which required taxpayers to explicitly add wages to their income, as computed for Federal tax purposes.⁴⁰ As a result of this change in form, the MGRT is less likely to be chastised for discouraging job creation in Michigan.

36. Range of State Corporate Income Tax Rates (2008), FEDERATION OF TAX ADMINISTRATORS, available at http://www.taxadmin.org/fta/rate/corp_inc.html (last visited July 2, 2008) (listing the 47 states with some form of corporate income taxes, with rates ranging from 1% to 10.84%). The press often simplistically compares states on the basis of their rates; however, no one serious about analyzing a corporate income tax would ignore the base of the tax.

37. For an extended justification for combined reporting and proposed solutions to most of its technical problems, see Michael J. McIntyre, Paul Mines, & Richard D. Pomp, *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, 61 LA. L. REV. 699 (2001).

38. For a discussion of a throwback rule, see POMP & OLDMAN, *supra* note 8, at 10-21-10-22.

39. In 1996, Michigan was ranked in the top ten in terms of the regressiveness of its tax system. See Michael P. Ettlinger, *et al.*, *Who Pays? A Distributional Analysis of the Tax Systems of All 50 States*, CITIZENS FOR TAX JUSTICE (June, 1996), available at http://www.ctj.org/whop/whop_txt.pdf (last visited May 6, 2008). Since 1996, the Michigan tax system has become more regressive, due in part to cuts in the personal income tax rates. See State & Local Taxes Hit Poor & Middle Class Far Harder than the Wealthy, INSTITUTE ON TAXATION AND ECONOMIC POLICY (Jan. 7, 2003), available at <http://www.itepnet.org/wp2000/pr.pdf> (last visited May 6, 2008).

40. MICH. COMP. LAWS ANN. § 208.9(5) (West 2003). Ironically, although the explicit inclusion of wages became a lightning rod for critics of the SBT, the use of wages, which was already calculated for federal purposes, was once considered an administrative virtue of the SBT.

In some sense, Michigan's new business package is a rediscovery of the past.⁴¹ The SBT was adopted as a single tax to replace a corporate income tax and a host of other taxes.⁴² Now the SBT is being replaced with multiple taxes, including a business income tax.⁴³ Michigan, however, apparently has learned something from its past mistakes. The new corporate tax is definitely superior, in many of its technical features, to the old corporate tax. The new taxes are somewhat integrated, in the sense of using many of the same concepts and definitions, whereas the pre-SBT taxes, aside from the corporate tax, were a hodgepodge of fees and excises, often castigated as nuisance taxes. Unfortunately, the new package has a host of complex special features that can only be explained by politics running amok.⁴⁴ Nevertheless, the new package seems to have been shaped primarily by policy considerations. It appears to be designed to reduce taxes on businesses seeking to produce goods and services in Michigan and to make up the revenue by increasing taxes on businesses seeking to exploit the Michigan market.

II. CLASSIFYING THE MICHIGAN MODIFIED GROSS RECEIPTS TAX

By calling one of the components of the Michigan Business Tax a modified gross receipts tax (MGRT), the State has invited comparisons between its new tax and recent state taxes that are generally considered to be gross receipts taxes. The most notable addition to the list of state gross receipts taxes is Ohio's recently adopted Commercial Activity Tax (CAT).⁴⁵ The Ohio tax is described by the Ohio Department of Revenue as "an annual privilege tax measured by gross receipts on business activities in this state."⁴⁶ As discussed in greater detail below, the Ohio CAT is a pure business activities gross receipts tax, whereas the Michigan tax is an entirely different animal.

Section II.A, below, discusses various states with taxes that are labeled as gross receipts taxes but differ in essential ways. Section II.B explains how the MGRT acts as an innovative form of value-added tax and compares it to more familiar forms of value-added tax.

41. Indeed, Michigan's State Treasurer, Robert J. Kleine, who was appointed to that office in 2006 and who agreed that the SBT had to be eliminated, was one of the architects of the SBT in 1975 when he was director of the Office of Revenue and Tax Analysis. *See Under Assault*, *supra* note 17, at 309.

42. *See Mitchell*, *supra* note 18.

43. *See supra* text accompanying notes 9-13.

44. For example, the multitude of credits include a credit for infield renovations and for hosting certain motorsport events. MICH. COMP. LAWS ANN. §§ 208.1409(1)-(2) (West Supp. 2007).

45. *See* OHIO REV. CODE ANN. § 5751.02 (West 2008).

46. *See* General Information on the Commercial Activity Tax (CAT), OHIO DEPARTMENT OF TAXATION, available at <http://tax.ohio.gov> (accessed from homepage by selecting the "Business" tab, then selecting "Ohio Taxes," then selecting "Commercial Activity Tax," then selecting "General Information") (last visited May 6, 2008).

A. The Ambiguous Meaning of a Gross Receipts Tax

The State of Washington has long had a gross receipts tax, adopted during the Depression; Ohio has recently adopted one as well.⁴⁷ New Mexico also has a gross receipts tax.⁴⁸ Washington and Ohio use a traditional gross receipts tax, intended to tax business activity or “turnover.”⁴⁹ New Mexico’s gross receipts tax is actually a broad-based sales tax, intended to tax consumption.⁵⁰ Michigan’s gross receipts tax is fundamentally different from Washington’s and Ohio’s (which are similar to each other). Michigan’s is closer to New Mexico’s, in that both are intended to tax consumption, but structurally Michigan has adopted a value added form of taxing consumption, which is very different in form from New Mexico’s retail sales tax.

At their cores, a business-activities gross receipts tax and a consumption gross receipts tax differ in design and intent. The classic business activities gross receipts tax is Washington’s Business and Occupation Tax, known for short as the B&O tax.⁵¹ Washington imposes a general gross receipts tax on most business activity in the state,⁵² in lieu of a corporate income tax.⁵³ The economic incidence of the tax is intended to fall on businesses and not on consumers. Retailing is taxed at 0.471%; wholesaling and manufacturing are taxed at 0.484%.⁵⁴ The law specifically states that the gross receipts tax shall constitute part of the operating overhead of the business,⁵⁵ which is consistent with the goal of the tax falling on business. The inclusion in the tax base of the gross receipts tax itself likewise reflects this intent. In addition to its gross receipts tax, Washington imposes a 6.5% retail sales tax.⁵⁶ Accordingly, a retail sale in the state of Washington attracts two taxes—the 0.471% tax that the retailer must pay on its gross receipts for the privilege of doing business in Washington and the 6.5% tax that the purchaser must pay on the sale of product, measured by those same gross receipts. A 6.5% use tax complements the sales tax.⁵⁷

47. See WASH. REV. CODE ANN. §§ 82.04.010-900 (West 2006); OHIO REV. CODE ANN. §§ 5751.02-.98 (West 2008).

48. See N.M. STAT. ANN. § 7-9-4 (West 2008).

49. See Walter Hellerstein, Michael J. McIntyre & Richard D. Pomp, *Commerce Clause Restraints on State Taxation after Jefferson Lines*, 51 TAX LAW REV. 47, 77-78, (1995).

50. *Id.* at 90-92.

51. See WASH. REV. CODE ANN. §§ 82.04.010-900 (West 2006).

52. See WASH. REV. CODE ANN. § 82.04.220 (West 2008).

53. See JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 57 (2nd ed. 1994).

54. WASH. REV. CODE ANN. §§ 82.04.250, 82.04.270 (West 2006).

55. WASH. REV. CODE ANN. § 82.04.500 (West 2006).

56. WASH. REV. CODE ANN. § 82.08.020 (West 2006).

57. See WASH. REV. CODE ANN. §§ 82.12.010-.995 (West 2006).

The Ohio Commercial Activities Tax (CAT), adopted in 2005, is an annual privilege tax measured by gross receipts on business activities in Ohio.⁵⁸ The rate is 0.26%.⁵⁹ Gross receipts subject to the CAT are broadly defined to include most business types of receipts from the sale of property to those realized in the performance of a service.⁶⁰

In contrast to Washington and Ohio, New Mexico has a gross receipts tax intended to be a sales tax falling on the consumer. The tax is imposed at a rate typical of sales taxes—5%.⁶¹ Moreover, in common with state sales taxes and consistent with normative principles of a consumption tax, New Mexico provides exemptions for a wide range of business inputs, such as the sale of: tangible personal property for resale;⁶² services for resale;⁶³ property that becomes an ingredient and component of other manufactured property;⁶⁴ tangible personal property to persons engaged in the construction business;⁶⁵ feed and fertilizers;⁶⁶ agricultural-related inputs;⁶⁷ mining, milling, or oil-related business inputs;⁶⁸ processing of components or materials used in manufacturing;⁶⁹ and so forth.

The fact that New Mexico has a consumption gross receipts tax is not always appreciated. One source of confusion is that the tax is imposed on the vendor and not the consumer,⁷⁰ which is irrelevant in classifying the levy but nonetheless has helped obscure its classification. Misunderstanding may also arise from the lack of a provision common in retail sales taxes requiring the separate statement of the tax. Retailers in New Mexico, however, routinely separately state the gross receipts tax.⁷¹ Moreover, whether separately stated or not, the New Mexico gross

58. OHIO REV. CODE ANN. § 5751.02 (West 2008).

59. OHIO REV. CODE ANN. § 5751.03(a) (West 2008).

60. See OHIO REV. CODE ANN. § 5751.01(f) (West 2008). For a critique of gross receipts taxes, see James W. Wetzler, *A LAWMAKER'S GUIDE TO NON-INCOME BASED BUSINESS FRANCHISE TAXES* (2007), available at <http://www4.uwm.edu/business-research/upload/TaxGuide07wCover.pdf> (last visited Sept. 3, 2008); John L. Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, TAX FOUNDATION (Jan. 31, 2007), available at <http://www.taxfoundation.org/research/show/2180.html> (last visited June 24, 2008).

61. N.M. STAT. ANN. § 7-9-4 (West 2008).

62. N.M. STAT. ANN. § 7-9-47 (West 2008).

63. N.M. STAT. ANN. § 7-9-48 (West 2008).

64. N.M. STAT. ANN. § 7-9-46 (West 2008).

65. N.M. STAT. ANN. § 7-9-51 (West 2008).

66. N.M. STAT. ANN. § 7-9-58 (West 2008).

67. N.M. STAT. ANN. § 7-9-59 (West 2008).

68. N.M. STAT. ANN. § 7-9-65 (West 2008).

69. N.M. STAT. ANN. § 7-9-75 (West 2008).

70. N.M. STAT. ANN. § 7-9-4 (West 2008).

71. For a fuller discussion, see Hellerstein, McIntyre, & Pomp, *supra* note 49, at 86-93, from which parts of this section are drawn.

receipts tax is excluded from the base of the tax,⁷² which is a characteristic of retail sales taxes.⁷³

Another possible source of misunderstanding is the breadth of the New Mexico tax, especially in its coverage of services. For historical rather than normative reasons, retail sales taxes apply to a wide spectrum of tangible personal property but to a more limited number of services.⁷⁴ The New Mexico tax is notable for its broad coverage of services,⁷⁵ a feature consistent with both a broad-based retail sales tax and a broad-based gross receipts tax. The New Mexico exemption for services purchased for resale, however, is an indication that the tax should be viewed as a retail sales tax. Finally, its historical roots may explain confusion about the proper classification of the New Mexico tax. The early New Mexico gross receipts tax reached many non-retail sales of both services and tangible personal property.⁷⁶ Over time, however, many of the nonretail sales have been excluded from the tax base.⁷⁷

As this brief survey suggests, the label “gross receipts” can refer to a business activity/turnover tax or to a sales tax. These are inherently different types of taxes. Although Michigan calls its new tax a modified gross receipts tax, the emphasis should be on “modified” and not on “gross receipts.” The tax certainly has nothing in common with the Washington or Ohio gross receipts tax. It comes closer to being a tax on consumption but not like the retail sales that other states use. As discussed in the next section, the tax is more akin to a value-added tax.

B. Michigan's Modified Gross Receipts Tax is Best Described as a VAT

The predominant form of value-added tax is that imposed by all of the members of the European Union (EU).⁷⁸ Canada's Goods and Services Tax follows that model in its structural features. A European-style VAT is a transactional tax intended to be paid by the ultimate consumer but collected in stages from the retailer and any intermediaries, including the producer, wholesaler, and distributor. The basic nature of that VAT is specified in the following passage from the First VAT Directive of the European Commission:

72. N.M. STAT. ANN. § 7-9-3.5(A)(3)(b) (West 2008).

73. Hellerstein, McIntyre & Pomp, *supra* note 49, at 74-78.

74. See POMP & OLDMAN, *supra* note 8, at 6-24-6-29.

75. See N.M. STAT. ANN. § 7-9-3(F) (West 2007); see also DUE & MIKESSELL, *supra* note 53, at 320.

76. See DUE & MIKESSELL, *supra* note 53, at 55 n.17, 89.

77. See *id.* at 55 n.17.

78. Some countries, notably New Zealand and South Africa, have adopted VATs that depart from the European model in some significant respects. See SCHENK & OLDMAN, *supra* note 19, at 69-71. Those differences, however, are unimportant for purposes of this article.

The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions that take place in the production and distribution process before the stage at which tax is charged.

On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.⁷⁹

The European-style VAT is classified as a credit-invoice VAT.⁸⁰ In that system, the taxpayer computes its tax liability by determining the tax applicable to its output (tax rate multiplied by the price of the output) and subtracting from that amount its input credit—a credit allowed for previously paid taxes on its business inputs.⁸¹ For example, assuming a 10% VAT rate, a retailer selling goods purchased for \$50,000 and sold for \$60,000 would have an output tax of \$6,000 ($\$60,000 \times 0.10$), from which it would subtract its input credit of \$5,000 ($\$50,000 \times 0.10$), for a net VAT of \$1,000. The tax is remitted periodically (often monthly) to the tax authorities.

The VAT was invented to avoid the cascading effects associated with the traditional gross receipts tax of the type used by Washington and Ohio.⁸² A cascading effect, in this context, means that a taxable object is taxable on its full value each time it is transferred or “turned over.” The result is that a taxable object that is transferred only once, from producer to ultimate consumer, is taxed only once, whereas a taxable object that is transferred multiple times before reaching the ultimate consumer is subject to multiple levels of taxation.

For example, assume that ACo and BCo both produce widgets from materials that they produce themselves. ACo sells the widgets at retail for \$100 each. Assuming a tax rate of 10%, the tax on each widget would be \$10. Assume, however, that BCo sells its widgets to a distributor, which sells to retailers, which then sell to the consuming public. In a

79. First Council Directive of 11 April 1967 on the harmonization of legislation of member states concerning turnover taxes (67/227/EEC) (OH P 71, 14.4.1967, 1301), Art. 2, *quoted in* SCHENK & OLDMAN, *supra* note 19, at 17.

80. SCHENK & OLDMAN, *supra* note 19, at 38-39, 59-60.

81. *Id.*

82. France is generally credited as the inventor of the VAT. Its distinctive feature is that “it is not a cumulative levy like the general turnover taxes used in many other countries . . . These cumulative taxes are often referred to as ‘cascade taxes’ (*taxes à cascade*).” Martin Norr & Pierre Kerlan, *Taxation in France*, in WORLD TAX SERIES 976 (1966).

traditional gross receipts turnover tax, each widget would be taxed on each transfer, based on its fair market value in the relevant market. Thus, if BCo sold a widget to a distributor for \$50, the distributor sold it to the retailer for \$70, and the retailer sold it to a consumer for \$100, the total tax on the transfers would be \$22 (\$5 + \$7 + \$10). The cascading effect typically results in favoritism toward big businesses, which tend to be integrated, over small, unintegrated businesses.⁸³

The European-type VAT avoids the cascading effect by giving each participant in the production and sale process a credit for taxes paid by prior participants in that process.⁸⁴ In the example of ACo and BCo above, the distributor would have a tentative VAT of \$7 but would get an input credit of \$5 for the tax paid by BCo, resulting in a net tax liability of \$2. The retailer would have a tentative VAT of \$10 but would be allowed an input credit of \$7 (\$5 + \$2), for a net tax liability of \$3. The result would be that each widget produced by ACo and BCo would be subject to a total VAT of \$10, without regard to the number of intermediaries between the production of the widget and the ultimate sale to the consuming public.⁸⁵

The Michigan MGRT differs from a credit-subtraction VAT because the MGRT does not allow a credit for previously paid taxes. In the taxonomy of VATs, the MGRT is akin to a sales-subtraction VAT. In a sales-subtraction VAT, the taxpayer computes its VAT on the sale of goods and services by subtracting the amount of its inventory costs and other purchases from the amount of its sales and then multiplying the resulting number by the tax rate.⁸⁶ This adjustment can eliminate the cascading effect of the tax as effectively as granting an input credit. Although sometimes praised in the tax literature,⁸⁷ a sales-subtraction

83. In many countries, the value-added tax was introduced as a replacement for turnover taxes, similar to the cascading taxes used in Washington and Ohio. One of the arguments made against those turnover taxes was that they provided a tax incentive for businesses to integrate when otherwise they would not have done so. See SCHENK & OLDMAN, *supra* note 19, at 4. As discussed in the text, a VAT eliminates that incentive.

84. *Id.* 38-39.

85. If a state had an ideal 10% retail sales tax, which exempted all business inputs, it would also collect \$10, the same as under the VAT example in the text. The major difference, however, is that the VAT is collected in stages whereas under an ideal sales tax, the \$10 would be collected once at the retail sale. If the retailer failed to collect or remit the \$10, the state would lose the full amount of the sales tax. Under the example in the text, if the retailer failed to collect or remit the tax collected from the consumer, the taxing jurisdiction would lose only \$3, the difference between the \$10 imposed on the retailer and the \$7 input credit. This feature of a VAT is especially attractive to a country that fears it has a high rate of tax avoidance at the retail level because of the large number of small retailers dealing in cash.

86. SCHENK & OLDMAN, *supra* note 19, at 42.

87. See Oliver Oldman & Alan Schenk, *The Business Activities Tax: Have Senators Danforth & Boren Created a Better Value Added Tax?*, 65 TAX NOTES 1547 (Dec. 19, 1994).

VAT is not common. It was once used by Finland,⁸⁸ and it is now in use by the Navajo Nation.⁸⁹ We are unaware of other examples of that type of tax.

Consistent with the theory of a sales-subtraction VAT, the Michigan MGRT allows a deduction from the tax base for inventory costs and other “purchases from other firms.”⁹⁰ In the example above, neither ACo nor BCo would have any deductions because they made no purchases from other firms. ACo would pay a tax of \$10 per widget, and BCo would pay a tax of \$5. BCo’s distributor would pay a tax of \$2 per widget, computed by subtracting \$50 (its purchases from BCo) from its sales of \$70 and multiplying the result by the tax rate of 10%. The retailer would have a tax per widget of \$3, computed by subtracting \$70 from its sales price of \$100 and multiplying the difference by 10%. In this stylized example, the result is identical to the result reached under a credit-subtraction VAT.⁹¹

One practical difference between a credit-invoice VAT and a sales-subtraction VAT is that a taxpayer making a purchase under the former system is entitled to an input credit only if VAT was previously paid with respect to that purchase.⁹² In principle, a taxing jurisdiction using a sales-subtraction VAT could achieve a comparable result by allowing a deduction from the tax base only for purchases made from sellers subject to the MGRT. The Michigan MGRT has no comparable limitation.⁹³ Such a rule would be impractical for Michigan because it would require Michigan to establish a registration system for sellers; both domestic sellers and foreign sellers would need to be required to register. Getting foreign sellers to register is a practical impossibility.

88. See Carl S. Shoup, *Choosing Among VATs*, in *VALUE-ADDED TAX IN DEVELOPING COUNTRIES* 14 (Malcolm Gillis et al., eds., 1990).

89. See NAVAJO NATION CODE tit. 24, §§ 404-05, available at <http://www.navajotax.org> (accessed from homepage by selecting “Statutes,” then “Business Activity Tax”) (last visited May 7, 2008). The authors consulted with the Navajo Nation on the design of this tax and one of us (McIntyre) produced the first draft of the tax, drawing from the experience of the Michigan SBT with an origin-based VAT. The tax raised over \$13 million for the Navajo Nation in 2007.

90. See MICH. COMP. LAWS ANN. § 208.1113(6) (West Supp. 2007).

91. We do not attempt here to catalogue the various practical differences typically resulting from a sales-subtraction VAT and a credit-subtraction VAT. For countries using multiple tax rates, the differences can be quite large since a credit-subtraction VAT typically allows a credit only for taxes actually paid, whereas a sales-subtraction method typically allows a deduction if the prior sale was subject to tax, regardless of the rate of that tax.

92. SCHENK & OLDMAN, *supra* note 19, at 41.

93. Professor McLure refers, disparagingly, to a sales-subtraction VAT that allows a deduction for purchases from persons not subject to the VAT as the “naive sales-subtraction VAT.” See CHARLES E. MCLURE, JR., *THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION* 71-79 (American Enterprise Institute 1987). Japan’s VAT is a naive sales-subtraction tax that does not rely on invoices for determining the amount of tax due. SCHENK & OLDMAN, *supra* note 19, at 41.

Although the Michigan MGRT has strong similarities to a sales-subtraction VAT, it also differs from such a tax in several important ways. Perhaps the most important difference is in the method of computing the tax. In contrast to a European-style VAT, a sales-subtraction VAT and the MGRT are not transactional taxes. Instead, the tax is computed at the end of each taxable period based on information contained in the taxpayer's books of account. In a sales-subtraction VAT, the tax is computed by adding up all of the taxpayer's sales within the taxing jurisdiction. In contrast, a taxpayer computes its tax due under the MGRT by determining its worldwide sales and worldwide purchases from other firms, and then apportioning a share of the worldwide modified gross receipts to Michigan, using a sales-only apportionment formula (Michigan sales/worldwide sales).⁹⁴

The use of a sales-only apportionment formula is critical to the success of the MGRT as a destination-based VAT. That mechanism substitutes for the border adjustments found in transactional VATs, which have the effect of exempting the value-added attributable to exports and taxing the value-added attributable to imports. As a result of apportionment, the taxable base of the MGRT is a crude approximation of the tax base that would result if Michigan were to impose an EU-type VAT—that is, a destination-based, transactional VAT.

For a highly stylized example of the rough equivalence of the MGRT and a credit-subtraction VAT, consider ACo, a company that produces bread in Michigan worth \$8,000 (net of tax). ACo sells one half of the bread in Michigan and the rest outside of Michigan. It purchases wheat grown in Michigan from BCo that has a value (net of tax) of \$1,000. BCo has no purchases from other firms. The VAT tax rate is 10%, and the tax is presumed to be shifted forward to purchasers. Under a EU-style VAT, BCo pays a tax of \$100 on the sale of wheat to ACo and charges ACo \$1,100 for the wheat. ACo sells the bread to Michigan customers for \$4,000 plus a tax of \$400. It is allowed an input credit of \$50 on the Michigan sales for the tax paid to BCo. ACo does not charge any VAT on its export sales. In addition, it gets a rebate of \$50 on those sales. The result is that ACo pays a net VAT of \$300 (\$400 - \$50 - \$50). The government, in total, collects a VAT of \$400 (\$300 from ACo and \$100 from BCo) with respect to \$4,000 sales of bread in Michigan.

The result would be roughly the same under a stylized version of the Michigan MGRT. Assuming that BCo sells the wheat to ACo for \$1,100, it has modified gross receipts of that amount, all of which presumably are apportioned to Michigan because the property was delivered or shipped to a purchaser in the State. Because the tax base of the MGRT includes the tax of \$100, the rate, to be comparable to the tax-exclusive VAT rate of 10%, would be 9.09% ($10\% / (100\% + 10\%)$). BCo pays a tax of \$100 ($\$1,100 \times 0.0909$).

94. MICH. COMP. LAWS ANN. §§ 208.1203(1), (3), 208.1301(2) (West Supp. 2007).

ACo has gross receipts of \$8,000 plus whatever taxes it passes on to its customers through higher prices. Assuming ACo passes on a 10% (tax exclusive) tax to its Michigan customers and no tax to its out-of-state customers, its gross receipts from Michigan sales are \$4,400 and its gross receipts from out-of-state sales are \$4,000, for a total of \$8,400. It gets a deduction of \$1,100 for purchases from other firms, giving it unapportioned adjusted gross receipts of \$7,300. Using the sales-only apportionment formula, the amount taxable by Michigan is \$3,825 ($\$7,300 \times \$4,400/\$8,400$), and the tax is \$348. The total MGRT collected by Michigan is \$448 (\$100 + \$348), which is \$48 (\$348 - \$300) more than the tax collected under the VAT.

The extra tax of \$48 paid under the stylized MGRT is due primarily to the fact that the VAT gives a full exclusion for taxes associated with exports, whereas the stylized MGRT, in the example above, does not.⁹⁵ That flaw could be fixed by allowing BCo to treat \$500 of its sales to ACo as out-of-state sales on the theory that half of the wheat ends up incorporated into exports. With that fix, BCo would charge ACo \$1,050 for the wheat and would pay a MGRT of \$50 ($(\$1,050 \times \$550/\$1,050) \times .0909$). BCo would have adjusted gross receipts of \$7,350 (\$8,400 - \$1,050), of which \$3,850 ($\$7,350 \times \$4,400/\$8,400$) would be apportioned to Michigan. The Michigan MGRT paid by ACo would be \$350 ($\$3,850 \times .0909$), and the total tax collected by the State would be \$400 (\$50 + \$350). The obvious problem with the fix is that it presents serious administrative problems.⁹⁶

To operate as a value-added tax, the Michigan MGRT must substantially eliminate all of the cascading effects of a traditional gross receipts tax. How well the MGRT protects against cascading depends on how broadly the State defines "purchases from other firms." In general, the statute defines that term broadly enough to cover purchases for resale⁹⁷ and purchases of depreciable property⁹⁸ and most other purchases of tangible personal property that constitute business inputs.⁹⁹ Purchases of land and certain other capital assets are not deductible,¹⁰⁰ but the proceeds from the sale of those assets, reduced by realized gains, are excluded from the tax base,¹⁰¹ which has the effect of including in the tax base only the gain on the sale. This result may be questionable as a

95. An alternative way to fix the flaw in the MGRT would be to include only Michigan sales in the tax base but still allow a full input credit on all purchases (assuming the only sales are taxable domestic sales and export sales).

96. See Section III.C.1 for a discussion of these problems and the ambiguity in Michigan law relating to the proper treatment of goods that are sold to a producer and incorporated into goods sold outside the State.

97. MICH. COMP. LAWS ANN. § 208.1113(6)(a) (West Supp. 2007).

98. MICH. COMP. LAWS ANN. § 208.1113(6)(b) (West Supp. 2007).

99. MICH. COMP. LAWS ANN. § 208.1113(6)(c) (West Supp. 2007).

100. MICH. COMP. LAWS ANN. § 208.1113(6) (West Supp. 2007).

101. MICH. COMP. LAWS ANN. § 208.1111(1)(o) (West Supp. 2007).

policy matter, but it will not lead to cascading. In contrast, amounts paid to purchase most types of business services are not deductible.¹⁰² Therefore, when services constitute a significant business input, the risk of a cascading effect could be quite significant.

In addition to allowing a deduction for certain business purchases, the Michigan MGRT protects against cascading for unitary businesses by eliminating all transactions between members of a unitary group, including the sales of services.¹⁰³ This protection extends to intercompany transactions that would not fall within the definition of "purchases from other firms."¹⁰⁴ The result is that members of a unitary group are protected from the cascading effect even with respect to services received from other members of that group. As noted above, other companies do not enjoy comparable protection.

The MGRT cannot be viewed as a success unless it can be administered effectively. At least in theory, the MGRT, with its apportionment formula, should be considerably easier to enforce than a transactional sales-subtraction VAT because the apportionment mechanism eliminates the need for the State to keep track of export sales (that is, sales outside of Michigan). The State still must determine the amount of Michigan sales, although only in the aggregate.¹⁰⁵ As discussed below in Section III.C, making that determination is not trivial. Nevertheless, the State previously was required to make that determination in applying the SBT apportionment formula, and that determination is also required under the new business income tax.¹⁰⁶

By reputation, a transactional VAT is supposed to protect against tax fraud because of a self-policing feature. If a taxpayer makes a purchase from a vendor that has failed to pay its VAT, the taxpayer will be unable to obtain a deduction, in the case of a sale-subtraction VAT, or an input credit, in the case of a credit-subtraction VAT, with respect to its purchases from that vendor.¹⁰⁷ As a result, a taxpayer has an interest in

102. A deduction is allowed for taxpayers that purchase and resell personal services. *See* MICH. COMP. LAWS ANN. § 208.1113(6)(d) (West Supp. 2007). A deduction also is allowed for certain subcontractors. *See* MICH. COMP. LAWS ANN. § 208.1113(6)(e) (West Supp. 2007).

103. *See* MICH. COMP. LAWS ANN. § 208.1511 (West Supp. 2007). Michigan allows an exemption for small businesses with gross receipts under \$350,000, so only purchases from larger firms face a double tax. *See* MICH. COMP. LAWS ANN. § 208.1505(1) (West Supp. 2007).

104. *See* MICH. COMP. LAWS ANN. § 208.1511 (West Supp. 2007) (excluding *all* transactions between persons included in the unitary business group from the combined return).

105. *See* MICH. COMP. LAWS ANN. § 208.1303(1) (West Supp. 2007).

106. *See* discussion *infra* part III.C.

107. *See* Kwang Choi, *Value-added Taxation: Experiences and Lessons of Korea*, in *TAXATION IN DEVELOPING COUNTRIES* 385 (Richard M. Bird & Oliver Oldman, eds., 4th ed., 1990):

The VAT is said to be self-enforcing because of how it is usually administered. There is a measure of self-policing in that evasion by suppliers through the

seeing that its vendors report their VAT properly. This self-policing feature is far from perfect—the Europeans have been experiencing significant problems with VAT fraud in recent years.¹⁰⁸ Little doubt exists, however, that the self-policing feature of the EU VAT has some value in preventing tax avoidance and evasion. The MGRT will not enjoy this self-policing feature because it permits deductions for purchases from other firms without any inquiry into whether those firms have complied with their tax obligations.

III. STATUTORY ANALYSIS OF THE MICHIGAN MGRT

A. Overview of the MGRT Statute

The Michigan Business Tax statute imposes a modified gross receipts tax on every taxpayer with nexus in the State.¹⁰⁹ That tax is imposed on the modified gross receipts tax base, after allocation or apportionment to Michigan.¹¹⁰ The basic rate is 0.8%,¹¹¹ increased by a surcharge of 21.99%,¹¹² bringing the total tax rate of the MGRT to just under 1%.¹¹³

“Gross receipts” under the MGRT means the entire amount received by the taxpayer from any activity “whether in intrastate, interstate, or foreign commerce carried on for direct or indirect gain, benefit, or advantage to the taxpayer . . .”¹¹⁴ This broad definition indicates the Legislature intended to cast a wide net.

“Taxpayer” includes, *inter alia*, individuals, firms, limited partnerships, limited liability partnerships, partnerships, joint ventures, associations, corporations, limited liability companies, estates, and

understatement of the tax collected is balanced by the purchasers’ interest in ensuring that all tax payments are recorded. Similarly, evasion by purchasers who overstate the taxes they pay runs counter to the interests of suppliers. The advantages of the invoice method have not been fully realized in practice.

Id.

108. See Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax to combat tax evasion connected with intra-Community transactions, Commission of the European Communities (2008), available at http://eur-lex.europa.eu/RECH_mot.do (accessed from homepage by typing “Directive 2006/112/EC” in the search box and selecting “PDF” under the “COM (2008) 0147” entry) (last visited May 16, 2008); see also Vanessa Houlder, *Surge in VAT fraud costs states up to €100bn*, FINANCIAL TIMES (Mar. 26, 2007), available at <http://www.ft.com> (accessed from homepage by entering keyword “Surge in VAT Fraud” in the Search field, then selecting “WORLD NEWS: Surge in VAT fraud costs states up to €100bn”) (last visited May 7, 2008).

109. See MICH. COMP. LAWS ANN. § 208.1203(1) (West Supp. 2007).

110. See *id.*

111. See *id.*

112. See MICH. COMP. LAWS ANN. § 208.1281(1)(a) (West Supp. 2007).

113. The actual combined rate is 0.976%.

114. MICH. COMP. LAWS ANN. § 208.1111(1) (West Supp. 2007).

trusts.¹¹⁵ It also includes a unitary business group, or any other group or combination of groups acting as a unit.¹¹⁶ Specifically excluded as taxpayers are the United States, states, political subdivisions, persons exempt under the Internal Revenue Code, nonprofit housing corporations, and farmer's cooperatives.¹¹⁷ In addition, a taxpayer earning gross receipts attributable to certain agricultural activities is exempt with respect to those gross receipts.¹¹⁸

The modified gross receipts tax base means a taxpayer's gross receipts less purchases from other firms before apportionment.¹¹⁹ Purchases from other firms includes, *inter alia*: (1) inventory acquired during the tax year, including charges for such things as shipping that are treated as inventory costs; (2) depreciable or amortizable assets, including the costs of fabrication and installation; and (3) materials and supplies, including repair parts and fuel.¹²⁰ With some modest exceptions for services that are, in effect, purchased for resale,¹²¹ purchases of services are not deductible. They would be deductible under a normative value-added tax.

The statute provides other exclusions from the tax base that are appropriate to refine the definition of a "gross receipt." For example, tax refunds¹²² and refunds from returned merchandise—essentially negative gross receipts—are excluded from that definition.¹²³

Other exclusions from the definition of gross receipts are questionable because they are not required to define properly a gross receipt.¹²⁴ Two notable exclusions are for the proceeds from the sale of land and most capital assets, less any gain from the sale of such assets to the extent included in federal taxable income.¹²⁵ The effect of this rule is

115. MICH. COMP. LAWS ANN. § 208.1113(3) (West Supp. 2007) (defining "person"); MICH. COMP. LAWS ANN. § 208.1117(5) (West Supp. 2007) (defining "taxpayer").

116. *Id.*

117. MICH. COMP. LAWS ANN. §§ 208.1207(1)(a)-(c), (e) (West Supp. 2007).

118. MICH. COMP. LAWS ANN. § 208.1207(1)(d) (West Supp. 2007).

119. MICH. COMP. LAWS ANN. § 208.1203(3) (West Supp. 2007).

120. MICH. COMP. LAWS ANN. §§ 208.1113(6)(a)-(c) (West Supp. 2007).

121. MICH. COMP. LAWS ANN. §§ 208.1113(6)(d)-(e) (West Supp. 2007).

122. MICH. COMP. LAWS ANN. § 208.1111(1)(k) (West Supp. 2007).

123. *See* MICH. COMP. LAWS ANN. § 208.1111(1)(h) (West Supp. 2007). Unexceptional exclusions include amounts received in an agency capacity, section 208.1111(1)(a), (b) (presumably these amounts will constitute the gross receipts of the principal); discounts, section 208.1111(1)(i), (j); security deposits, section 208.1111(1)(l); the original issue of stock or equity instruments, section 208.1111(1)(g); or *payment* of the principal portion of loans, section 208.1111(1)(m) (emphasis added). Presumably the Legislature did not mean "payment" of the principal but rather the "receipt" by the taxpayer of the principal portion of loans.

124. The definition of gross receipts is largely taken from the comparable definition in the SBT. The exclusion for the proceeds from land and certain other capital transactions was taken directly from the SBT. *See* MICH. COMP. LAWS ANN. § 208.7(3)(o) (West 2003).

125. *See* MICH. COMP. LAWS ANN. § 208.1111(1)(o) (West Supp. 2007).

to treat only the gains derived from those sales as taxable gross receipts. In addition, presumably for administration reasons, the gains are taxable only if they have been included in federal taxable income.¹²⁶ The inclusion of only net gains on certain capital transactions is consistent with the denial of a deduction for the purchase of such assets under the adjustment for purchases from other firms. Of course, consistency also could be achieved by including the sales proceeds and deducting the initial purchases.¹²⁷

The MGRT applies to taxpayers “with nexus as determined under section 200.”¹²⁸ That section provides that substantial nexus in Michigan exists if the taxpayer has a physical presence in Michigan for a period of more than one day during the tax year or if the taxpayer actively solicits sales in the state and has gross receipts of \$350,000 or more attributed to Michigan.¹²⁹ The Michigan nexus rules are discussed in greater detail in Section III.B, below.

The MGRT tax base (as well as the tax base of the business income tax), are apportioned for taxpayers whose business activities are subject to tax both within and outside Michigan by using a sales-only apportionment formula.¹³⁰ The numerator of that formula is the total sales of the taxpayer in Michigan during the tax year, and the denominator is the total sales everywhere during that year.¹³¹ The apportionment rules are discussed in greater detail in Section III.C, below. Taxpayers engaged in business only in Michigan are not subject to apportionment; they have all of their adjusted gross receipts *allocated* to Michigan.¹³²

126. *See id.*

127. Other questionable exclusions from gross receipts include the proceeds representing the principal balance of loans transferred or sold by a mortgage company, MICH. COMP. LAWS ANN. § 208.1111(1)(s) (West Supp. 2007); and amounts received by a professional employer organization as reimbursement for its actual cost of wages, benefits, taxes and the like for an employee provided to the customer. MICH. COMP. LAWS ANN. § 208.1111(1)(t) (West Supp. 2007). The MBT also excludes from the definition of a gross receipt the proceeds from the transfer of an account receivable if the sale that generated the account receivable was included in the gross receipts for federal income taxes. *See* MICH. COMP. LAWS ANN. § 208.1111(1)(f) (West Supp. 2007). That exclusion illustrates a conundrum unique to gross receipts taxes. The Legislature presumably felt that it would be improper to treat the initial sale creating the account receivable as a gross receipt and also treat the sale of that receivable as a gross receipt. Eliminating that overlap would seem to be proper, at least in a tax seeking to operate as a VAT. In effect, the taxpayer is treated as if it had purchased the receivable from its customer when it provided the customer with the goods and services that caused the receivable to be created. That imputed purchase is allowed to offset the proceeds derived from the sale of that receivable.

128. *See* MICH. COMP. LAWS ANN. § 208.1203(1) (West Supp. 2007).

129. MICH. COMP. LAWS ANN. § 208.1200 (West Supp. 2007).

130. *See* MICH. COMP. LAWS ANN. §§ 208.1301(1), (2) (West Supp. 2007).

131. *See* MICH. COMP. LAWS ANN. § 208.1303(1) (West Supp. 2007).

132. *See* MICH. COMP. LAWS ANN. § 208.1303(2) (West Supp. 2007).

The Michigan statute incorporates the concept of a unitary business, developed in the context of state corporate income taxes, into the MGRT. The SBT contained no similar concept, resulting in the creation of many tax-minimization strategies for multistate corporations. In general, commonly controlled firms operating a unitary business are treated as a single firm, and all transactions within the unitary group are ignored for purposes of the MGRT.¹³³ Similar rules apply for purposes of the Michigan business income tax. The treatment of members of a unitary group of firms is addressed in greater detail in Section III.D, below.

The MBT provides a panoply of new credits available to all MBT taxpayers, including taxpayers under the MGRT. These credits are intended to favor those taxpayers with significant business operations in Michigan.¹³⁴ The MBT also terminates certain credits available under the SBT.¹³⁵ A taxpayer with gross receipts no greater than \$700,000 is allowed a credit that eliminates a portion of its tax liability under the MBT.¹³⁶

Taxpayers (other than insurance companies and financial organizations) are not required to file a tax return or pay tax under the MBT if their allocated or apportioned gross receipts are less than \$350,000.¹³⁷ The \$350,000 threshold corresponds with the economic nexus threshold of the same amount, discussed in Section III.B, below.

B. Nexus to Tax

1. Background

The gross receipts tax applies to taxpayers “with nexus” in Michigan.¹³⁸ The statute does not define nexus but instead provides two ways of satisfying *substantial* nexus: (1) having a physical presence in Michigan for more than one day during the tax year, or (2) actively soliciting¹³⁹ sales in Michigan and having Michigan gross receipts of at

133. See discussion *infra* Parts III.D.

134. See MICH. COMP. LAWS ANN. § 208.1401 (West Supp. 2007).

135. See *id.*

136. See MICH. COMP. LAWS ANN. § 208.1411 (West Supp. 2007). The point of the credit is to avoid the so-called “cliff” problem that results when a dollar of additional gross receipts causes the taxpayer to pay more than a dollar in tax.

137. See MICH. COMP. LAWS ANN. § 208.1505(1) (West Supp. 2007).

138. MICH. COMP. LAWS ANN. § 208.1203(1) (West Supp. 2007).

139. The statute provides that the tax department “through written guidance that shall be applied prospectively” will define active solicitation. MICH. COMP. LAWS ANN. § 208.1200(2) (West Supp. 2007). Pursuant to that authorization, the Department issued Revenue Administrative Bulletin 2007-6. In that Bulletin, the Department defined active solicitation as meaning (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly nor implicitly invite an order but are entirely ancillary to requests for an order. Active solicitation includes, but is not limited to, solicitation through (1) the use of mail, telephone, and e-mail; (2) advertising, including print, radio, internet, television, and other media; and (3) maintenance of an internet site

least \$350,000.¹⁴⁰ For convenience, we will refer to these alternatives as “physical presence” and “economic presence,” respectively.

These two alternative grounds for nexus are best understood in the context of a debate raging among the states and taxpayers over the proper interpretation of the U.S. Supreme Court’s 1992 decision in *Quill Corp. v. North Dakota*.¹⁴¹ That case concerned whether North Dakota could require Quill, an out-of-state mail-order house that had no outlets or sales representatives in the State, to collect a use tax on goods shipped to customers in North Dakota.¹⁴² Twenty-five years earlier, in *National Bellas Hess v. Illinois*,¹⁴³ the Court had ruled that a seller whose “only connection with customers in the State is by common carrier or the United States mail”¹⁴⁴ lacked the requisite minimum contacts necessary for the state to be able to compel it to collect the use tax.¹⁴⁵

In *Quill*, the Court first held that the taxpayer “had purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits [the taxpayer] receives from access to the State.”¹⁴⁶ It wasn’t enough, however, for Quill to have sufficient contacts (nexus) under the Due Process Clause. The Court also required that Quill have nexus under the Commerce Clause.¹⁴⁷ Latching onto dictum in *Complete Auto Transit v. Mississippi*,¹⁴⁸ the Court held that the remote vendor must have “a substantial nexus” with a state in order for the state to have the power to compel the vendor to collect the use tax.¹⁴⁹

The Court adopted in *Quill* what it referred to as the “*Bellas Hess* rule,” meaning that physical presence will satisfy the substantial nexus requirement.¹⁵⁰ The Court claimed that one benefit of such a rule was that it provides a bright-line test that would reduce the likelihood of

over or through which sales transactions occur with persons within Michigan. In evaluating whether acts of solicitation are sufficient to establish active solicitation, the Department will look to the quality, nature, and magnitude of the activity on a facts and circumstances basis.

140. See MICH. COMP. LAWS ANN. § 208.1200(1) (West Supp. 2007).

141. 504 U.S. 298 (1992).

142. See generally *id.*

143. 386 U.S. 753 (1967).

144. *Id.* at 758.

145. See *id.*

146. *Quill*, 504 U.S. at 308.

147. *Id.* at 312.

148. 430 U.S. 274 (1977).

149. *Quill*, 504 U.S. at 312. For a critical analysis of *Quill*, see Richard D. Pomp and Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers after Quill: An Evaluation of MTC Bulletin 95-1*, 11 STATE TAX NOTES 177 (1996), excerpted in POMP & OLDMAN, *supra* note 8, at 9-71. See also Richard D. Pomp and Michael J. McIntyre, *Adrift Without a Rudder—A Response to Seaman Miethke*, 11 STATE TAX NOTES 487 (1996).

150. *Quill*, 504 U.S. at 317-18.

litigation.¹⁵¹ Furthermore, “a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals.”¹⁵² As the discussion below suggests, the substantial nexus line is not as bright as the Court may have intended.

2. Substantial Nexus and Michigan's One-Day Rule

The Michigan statute uses the term “substantial nexus” in defining its nexus standard, mirroring the term used in *Quill*.¹⁵³ The Supreme Court, however, did not define “substantial nexus.” In acknowledging that the bright line, physical-presence test might appear artificial at its edges, it stated that “whether or not a State may compel a vendor to collect a sales or use tax may turn on the *presence in the taxing State of a small sales force, plant, or office*.”¹⁵⁴ This statement is hardly a clear statement of the law of nexus. It implies that a small sales force, plant, or office could constitute the kind of physical presence that the Court will accept as substantial nexus under the Commerce Clause. It does not indicate how small that sales force, plant, or office could be and still constitute substantial nexus, nor does it give any clue as to how long the sales force, plant, or office must exist in the state to constitute substantial nexus. Nor does it indicate that a sales force, plant, or office is required for nexus, rather than merely being sufficient for nexus. Those questions have been left for others to answer, at least for now.

The Michigan statute provides one possible answer to the duration question by defining substantial nexus as a “physical presence for more than one day.”¹⁵⁵ That answer is on the aggressive side, although not foreclosed by the language of *Quill*.

The statute is silent on the qualitative nature of the physical presence. Is mere physical presence for a day enough, or is there some implicit requirement that the physical presence advance the taxpayer's business in some non-trivial way? For example, a salesperson who flies into Detroit the night before taking a client out to lunch and then flies home afterwards will have spent more than one day in Michigan (at least if part of a day counts as a whole day). Although the client may be impressed with this visit, a court may be less so, especially if no business was discussed during that visit.

151. *Id.* at 315-16.

152. *Id.* at 316.

153. See MICH. COMP. LAWS ANN. § 208.1200(1) (West Supp. 2007); *Quill* 504 U.S. at 311.

154. *Quill*, 504 U.S. at 315 (emphasis added).

155. See MICH. COMP. LAWS ANN. § 208.1200(1) (West Supp. 2007).

One of the authors (McIntyre) has suggested a minimalist reading of *Quill*,¹⁵⁶ a position that has found some support from the Wyoming Supreme Court¹⁵⁷ and might support the minimalist reading of *Quill* implicit in Michigan's nexus standard. His article challenges a common reading of *Quill* that physical presence is required for nexus. Instead, the article argues that physical presence is a sufficient condition but not a necessary one:

The [*Quill*] Court . . . established two safe-harbor rules governing the collection obligations of remote sellers, one favoring the states and the other favoring the remote seller . . . The first safe-harbor rule . . . is that the remote seller has nexus . . . if it has a physical presence in the state and that physical presence is not *de minimis*. Under the second safe-harbor rule, drawn from *Bellas Hess*, a remote seller does not have nexus with a state if it does not have a physical presence in the state (other than the *de minimis* amount) and its "only connection with customers in the [taxing] state is by common carrier or the United States mail."¹⁵⁸

The second rule is labeled the "brown truck" rule, after the color of the trucks used by UPS.¹⁵⁹ Presumably, Michigan would be prepared to argue that one day of physical presence is not *de minimis* under the suggested safe-harbor rule.

3. Nexus from Presence of Employees, Agents, and Independent Contractors

A corporation, which is a legal construct, cannot have physical presence of its own anywhere. Nevertheless, it can be present in a state through property it owns or leases, or through those acting on its behalf. The Michigan statute addresses this latter situation by providing that:

156. See generally, Michael J. McIntyre, *Taxing Electronic Commerce Fairly and Efficiently*, 52 TAX L. REV. 625 (1997).

157. See *Buehner Block Co., Inc. v. Wyoming*, 139 P.3d 1150 (Wyo. 2006):

The bright-line rule of *National Bellas Hess* and *Quill* does not require physical presence in a state. Rather, the bright-line rule simply holds that, where there is no physical presence in a state, and the only connection between the state and the entity or transaction is by mail or common carrier, there is no "substantial nexus" that will support imposition of a sales or use tax. The requirement of a substantial nexus, rather than the requirement of actual physical presence, necessarily implies that something less than physical presence may suffice.

Id.

158. McIntyre, *supra* note 156, at 637. The views expressed in the text are more fully developed in McIntyre, *supra* note 156, at 636-51.

159. *Id.* at 637-38.

[P]hysical presence means any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity. Physical presence does not include the activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in [Michigan].¹⁶⁰

Oddly, the Michigan statute does not expressly assert that a business can have nexus through the property it owns or leases in the State. It focuses only on nexus through the presence of representatives.¹⁶¹ The Supreme Court has clearly held, however, that the ownership or leasing of property provides substantial nexus.¹⁶² Perhaps the drafters simply assumed that holding property so obviously constituted a nexus-creating "activity conducted by the taxpayer" that a mention in the statute was not needed. Or the drafters may have nodded, or perhaps, less likely, they decided for unknown reasons not to assert nexus based on a taxpayer's property holdings in Michigan.

The nexus section of the Michigan statute recognizes that corporations hire many different kinds of persons who act as independent contractors, representatives, or agents, such as lawyers, architects, advertising brokers, accountants, bankers, purchasing agents, actuaries, freight forwarders, engineers, insurance agents, pension administrators, mortgage brokers, and the like. Corporations also use third parties to make sales into a state. Only those persons acting for a taxpayer in a "representative capacity" create nexus for the taxpayer under Michigan's physical-presence test.

An initial question in interpreting the statute is whether the requirement of "acting in a representative capacity" modifies only independent contractors or also modifies employees and agents. The argument that the requirement does not modify employees is that such persons are typically viewed as constituting physical presence for Commerce Clause purposes regardless of the nature of their non-*de minimis* activities.¹⁶³ Many employees who commonly would be viewed as creating nexus would not be described as acting in a representative capacity. A taxpayer's secretary present in the state, for example, would

160. MICH. COMP. LAWS ANN. § 208.1200(3) (West, Supp. 2007).

161. *See id.*

162. *See generally* Nat'l Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551 (1977); *Quill*, 504 U.S. 298.

163. Despite *Quill's* emphasis on a bright line test, there are a small number of cases holding that an employee does not constitute Commerce Clause nexus for the sales and use tax based on what appears to be a quantitative and qualitative analysis. *See* POMP & OLDMAN, *supra* note 8, at 9-69. These cases, however, did not turn on whether the employees were "representing" their employers.

not be considered as “representing” the taxpayer, yet the secretary would more than likely constitute a physical presence in the state of the employer. Assuming the Legislature intended to adopt a physical-presence test as broad as is permitted under the Court’s Commerce Clause jurisprudence and that it did not intend to upset the common understanding that employees create nexus regardless of their activities, two interpretations of the statute are possible. One is that employees should always be viewed as acting in a representative capacity, even if that reading of the literal language of the statute is somewhat strained. The other interpretation is that the “acting in a representative capacity” requirement only applies to independent contractors.

The difficulty with the latter interpretation is that it would leave “agents” free of the “acting in a representative capacity” requirement without any strong rationale for treating them differently from independent contractors.¹⁶⁴ Unlike employees, agents are not viewed as automatically constituting physical presence regardless of the nature of their activities.¹⁶⁵ In this respect, they are more similar to independent contractors. In short, the statute presents a dilemma. Employees should be treated differently from agents and independent contractors, and the latter two categories should be subject to the same rules. The statute, unfortunately, does not easily allow for such a construction.

4. Establishing and Maintaining a Market

To create nexus for its principal, the activities of a service provider must be “significantly associated with the taxpayer’s ability to establish and maintain a market in [Michigan].”¹⁶⁶ This language has its origins in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*,¹⁶⁷ a case involving the Washington business activities/gross receipts tax.¹⁶⁸ One issue in that case was whether Tyler Pipe had sufficient nexus with Washington to be subject to the gross receipts tax.¹⁶⁹ “Tyler maintain[ed] no office, own[ed] no property, and ha[d] no employees residing in the State of Washington. Its solicitation of

164. See generally *Tyler Pipe Indus., Inc. v. Wash. St. Dept. of Revenue*, 483 U.S. 232 (1987) (suggesting that, with respect to nexus, no constitutional difference exists between agents and independent contractors).

165. No cases exist, for example, holding that a lawyer or accountant or any of the similar categories discussed in the text create a nexus for the person hiring them solely because of their status as a representative, agent, or independent contractor.

166. The statute does not explicitly exclude employees from this category. Employees are certainly “service providers,” but obviously not all employees will be involved in establishing and maintaining a market. Literally interpreted, the statute would prevent many employees from creating nexus. Such an interpretation suggests that the “establishing and maintaining a market” requirement applies only to non-employees.

167. 483 U.S. 232 (1987).

168. See generally *id.* The Washington B&O tax is discussed above in Section II.A.

169. See *id.* at 249.

business in Washington [wa]s directed by executives who maintain[ed] their offices out-of-state and by an independent contractor located in Seattle.”¹⁷⁰ The Court held that nexus existed.¹⁷¹ It endorsed the statement of the Washington Supreme Court that “the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are *significantly associated with the taxpayer’s ability to establish and maintain a market* in this state for sales.”¹⁷² The Court also agreed with the State court that the existence of nexus “could not be defeated by the argument that the taxpayer’s representative was properly characterized as an independent contractor instead of as an agent.”¹⁷³ The Court characterized the independent contractor as a representative,¹⁷⁴ suggesting that independent contractors, representatives, and agents were viewed the same when it came to nexus.

The Court has never elaborated on the nature of a representative’s activities that will be viewed as establishing or maintaining a market. Litigation can be expected now that Michigan has statutorily embodied all of these terms without defining them. Some types of activities, such as holding out the taxpayer’s products for sale to customers, would clearly constitute market enhancing, nexus creating activities. But other cases are far less clear. A lawyer who draws up the critical sales contract that a business firm uses in Michigan, or who sues the firm’s competitor to keep it out of the Michigan market, could be described as satisfying the statutory nexus-creating requirements of representing the taxpayer and being involved in “establishing or maintaining a market;” yet a finding of nexus would contradict common understanding of the tax effects of hiring a lawyer. Some guidance from the Michigan Department of Treasury on this issue clearly is warranted.

The activities of independent contractors, agents, or representatives can be arrayed on a continuum. At one end are sales activities and market-related activities, such as soliciting sales on behalf of the taxpayer.¹⁷⁵ At the other end are activities having nothing to do with the solicitation or generation of sales, such as the activities of an accountant or a stockbroker. The issue is where on the continuum to draw the nexus-creating line. To be sure, corporations are in the business of making a profit from selling goods or providing services, so that on a general level everyone hired, whether an employee or a third-party, ultimately contributes to the corporation’s ultimate economic well being. That logic, however, would mean that a corporation would have nexus in any

170. *Id.* at 249.

171. *Id.* at 251.

172. *Id.* at 250 (emphasis added).

173. *Tyler Pipe*, 483 U.S. at 250.

174. *Id.*

175. *See generally* *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) (holding that a nexus exists when persons variously described as brokers, wholesalers, jobbers, or independent contractors, solicit sales on a commission basis for out-of-state taxpayer).

state in which any independent contractor, agent, or representative performed services on its behalf—a position that no state has ever taken and that no commentator has ever endorsed.

Instead, the line that many states seem to have drawn is that the purchase of services from local firms, such as the use of lawyers, bankers, or accountants, will not be viewed as creating nexus.¹⁷⁶ For example, an independent contractor, agent, or representative selling goods or services in Michigan on behalf of an out-of-state corporation would create nexus. But nexus would not result from the use of a Michigan law firm that drew up the sales contract, a Michigan advertising firm that created the commercials that advertised the product, a Michigan bank that financed the purchase of inventory, or a Michigan accounting firm that calculated the profit on the sale.

The line we are describing is prescriptive and not normative and is consistent with pragmatic considerations of economic development. No tax commissioner, unless compelled by the governing statute, is likely to adopt a position on nexus that offers out-of-state businesses an incentive to avoid using in-state service providers. A tax commissioner who broadly interpreted “establishing or maintaining a market” to cover the Michigan service providers described above would likely be overruled rather quickly by the Michigan Legislature.

Two situations illustrate how legislatures act to protect local industries from what would otherwise be viewed as nexus-creating events. In the first situation, an out-of-state corporation hires an in-state firm to print a catalog. The corporation may have its employees come to the printing firm’s premises when page proofs are being run in order to make last minute adjustments. In addition, the corporation might supply the printer with paper it purchased at wholesale in order to reduce costs. Having people and property in the state would normally create nexus. To protect the local printing industry, many states have passed legislation providing that nexus is not created when a taxpayer having no other nexus-creating contacts with a state uses an in-state printer, stores property at the printer’s plant for use in printing, or visits the printer’s plant.¹⁷⁷

In the second situation, an out-of-state corporation may appear at a Michigan trade show. Many states have convention centers that are a logical venue for trade shows. But trade shows will normally involve nexus-creating activities, discouraging out-of-state vendors that otherwise do not have nexus from exhibiting if they become subject to tax in the state on their subsequent sales when they return home. Accordingly, some states have adopted favorable rules specifying that limited use of a convention center will not constitute nexus.¹⁷⁸

176. See *supra* note 165.

177. See POMP & OLDMAN, *supra* note 8, at 9-70.

178. See *id.*

Of course, Michigan has not yet adopted legislation of the type discussed above. Its statutory nexus standard seems to extend about as far as *Quill* permits. The experience of other states suggests, nevertheless, that the Michigan's Department of Treasury is likely to interpret the term "establishing or maintaining a market" in a limited, rather than broad, manner when the latter reading of the nexus standard would put Michigan service firms at a significant competitive disadvantage.

5. Nexus from Economic Presence

The above discussion dealt with physical presence. The statute also defines substantial nexus in terms of economic presence: "the active solicitation of sales in Michigan and Michigan gross receipts of at least \$350,000."¹⁷⁹ Is this nexus test consistent with *Quill*? That case dealt with a traditional sales and use tax.¹⁸⁰ If the Michigan gross receipts tax is viewed as a sales and use tax, and if physical presence is viewed as a necessary condition for nexus, the economic-presence standard would be unconstitutional.

As discussed in Section II.B, above, the Michigan MGRT is not the type of traditional retail sales tax that was before the Court in either *Bellas Hess* or *Quill*.¹⁸¹ True, the tax may be intended to fall on consumption, similar to a sales and use tax. But the similarity ends there. Moreover, the *Quill* Court, at least to some extent, was protecting reliance interests based on *Bellas Hess*.¹⁸² Taxpayers under the Michigan MGRT have no claim to such protection. If the MGRT is not viewed as a traditional sales and use tax, as seems likely, then the constitutionality of its economic-presence test turns on whether the physical-presence test must be satisfied for taxes other than sales and use taxes.

The application of *Quill* and its physical-presence test to taxes other than sales and use taxes has been litigated heavily throughout the country,¹⁸³ usually in the context of the required nexus standard for corporate income taxes. Those who argue in support of an economic-presence test for income taxes contend that *Quill* has limited application outside of sales and use taxes. They have had some recent successes in the courts. For example, the West Virginia Supreme Court recently rejected physical presence as the appropriate nexus standard in an income tax and endorsed an economic-presence standard.¹⁸⁴ The taxpayer in that case, MBNA America Bank, issued credit cards and

179. MICH. COMP. LAWS ANN. § 208.1200(1) (West Supp. 2007).

180. See generally *Quill*, 504 U.S. 298.

181. See discussion *supra* Part II.B.

182. See *Quill*, 504 U.S. at 317.

183. See, e.g., *Lanco v. Dir. Div. of Taxation*, 879 A.2d 1234 (N.J. 2005); *Tax Comm'r v. MBNA Am. Bank*, 640 S.E.2d 226 (W. Va. 2006), and the cases cited therein.

184. See generally *Tax Comm'r v. MBNA Am. Bank*, 640 S.E.2d 226 (W. Va. 2006).

earned money from their use. The court held that MBNA did not satisfy the physical-presence standard because it had no people or property in the State but nonetheless had substantial nexus under the economic-presence standard because of the frequency and systematic nature of the company's contacts with West Virginia in earning money from credit-card transactions conducted in the state.¹⁸⁵

Proponents of an economic-presence standard for taxes other than sales and use taxes usually emphasize the nature of the modern U.S. economy, which allows remote vendors to benefit substantially from a state's marketplace without having a physical presence in the state.¹⁸⁶ They also stress two passages in *Quill*: (1) "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use tax;"¹⁸⁷ and (2) "[a]lthough we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule."¹⁸⁸ They also emphasize the acknowledgment of the *Quill* Court "that contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today,"¹⁸⁹ and the lack of a *Bellas Hess*-type precedent for taxes other than sale and use taxes.

Those who argue that physical presence is the appropriate nexus standard for all taxes, not just sales and use taxes, note that no Commerce Clause nexus case has ever involved a taxpayer that did not have a physical presence.¹⁹⁰ Consequently, they interpret the passages above from *Quill* as merely meaning that the Court has never had to articulate a physical-presence standard in the case of non-sales tax cases. Defenders of a general physical-presence standard assert that the benefits of a bright-line test cited by *Quill*—the reduction of litigation, the

185. See *MBNA America Bank*, 640 S.E.2d at 235.

186. See *id.*

187. *Quill*, 504 U.S. at 317.

188. *Id.* at 314.

189. *Id.* at 311.

190. The discussion in the text is based on an amalgamation of the arguments taxpayers have made in their briefs, and the testimony of expert witnesses on their behalf, as well as the states' arguments in cases such as *Capital One Bank and Capital One F.S.B. v. Commissioner of Revenue*, Mass. App. Tax Bd., Nos. C262391 & C262598, (June 22, 2007), *Lanco, Inc. v. Director of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S. Ct. 2974 (2007), *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. 2004), *cert. denied*, 126 S. Ct. 353 (2005), *Secretary, Dep't of Revenue, State of La. v. Gap (Apparel), Inc.*, 886 So.2d 459 (La. App. 2004), *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Civ. App. 2005), *Bridges v. Geoffrey, Inc.*, La. Ct. App., No. 2007 CA 1063 (Feb. 8, 2008). The opinions in these cases do not always reflect the full extent of the parties' arguments.

encouragement of settled expectations, the fostering of investment—would be undercut by the adoption of a new economic-presence standard with which the states have had little experience.

Supporters of an economic-presence test argue that this test need not create uncertainty as long as it is clearly stated, as it is under the Michigan statute. If properly formulated, the test arguably can be just as clear, or clearer, than the allegedly bright-line test of *Quill*. Opponents reply that two states can have conflicting bright-line tests; for example, in a case like MBNA, one state might locate income to the state where the credit card is used and another might locate it where the cardholder is billed. They suggest that uniformity is best achieved by Congress imposing a uniform standard.

Another argument that might be advanced for the economic-presence test is that this test, properly formulated, would give greater weight to substance than to form and might reduce opportunities for abusive tax avoidance. Of course, what is characterized as tax avoidance from one perspective may be characterized as legitimate tax minimization from a competing perspective. A commonly made argument for the test, perhaps of some appeal to local businesses, is that it may help protect them from the unfair competition that could result when taxpayers located outside the state engage in substantial business activities in the state without bearing any of the costs of government.¹⁹¹ Opponents respond by asserting that taxpayers lacking physical presence do not impose significant costs on a government and benefit only incidentally from services provided by a state to its citizens. No one can dispute, nevertheless, that taxpayers having economic presence benefit from the exploitation of the in-state market, although commentators may not agree on the significance of this point.

Whatever the merits of its position, Michigan can expect litigation over its use of an economic-presence test. We will not predict how the U.S. Supreme Court would decide if that issue were to reach it. In preparing to meet the almost inevitable challenges to the constitutionality of its economic-presence test, Michigan can take some comfort from the fact that the U.S. Supreme Court has denied *certiorari* in numerous cases asking for a resolution of whether physical presence or economic

191. Charles E. McLure, Jr. *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Law*, 52 TAX L. REV. 269, 296 (1997):

[E]xtension of existing nexus rules [physical-presence test] to electronic commerce would place local merchants at a competitive disadvantage, especially relative to large out-of-state competitors. Thus, it is essential that adoption of an economic nexus standard be accompanied by greater uniformity of state sales taxes and *de minimis* rules that would exempt out-of-state vendors making small amounts of sales into a state from the duty to collect use taxes.

Id.

presence is the nexus standard for taxes other than sales and use taxes.¹⁹² Certainly, the threat of litigation should not deter a state from adopting a rule that it considers to be both constitutional and significant. Otherwise, all contentious legal issues would be decided by default in favor of the taxpayer.

C. Apportionment of the Tax Base

The MBT statute defines the tax base of the MGRT as worldwide gross receipts reduced by worldwide purchases from other firms.¹⁹³ Both terms are defined broadly but not comprehensively. This tax base is then apportioned between Michigan and the rest of the world using a sales-only apportionment formula—that is, Michigan sales divided by worldwide sales.¹⁹⁴

The Michigan apportionment formula uses unadjusted gross proceeds from sales, rather than sales reduced by purchases from other firms, in the numerator and denominator of the apportionment fraction.¹⁹⁵ The effect of this rule is that deductions for purchases from other firms are allocated pro rata to sales (gross receipts), although those deductions may have a factual relationship to particular sales in some cases. Tying a specific purchase to a particular gross receipts, however, would be an extremely complex undertaking in many cases—an undertaking, Michigan wisely bypassed.

Section III.C.1 discusses some constitutional issues and concludes that apportionment of the tax base of the MGRT is required under the U.S. Supreme Court's dormant Commerce Clause jurisprudence and that the sales-only apportionment formula does not present any constitutional problems. Section III.C.2 discusses some practical problems that arise in applying an apportionment formula to determine Michigan sales.

1. Constitutional Considerations

The U.S. Supreme Court has long held that corporate income taxes must be fairly apportioned¹⁹⁶ and that virtually any reasonable apportionment formula will withstand constitutional challenge under the dormant Commerce Clause.¹⁹⁷ The issue is less clear for gross receipts taxes. The Supreme Court has held on some occasions that

192. See, e.g., *Geoffrey, Inc., v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), cert. denied 510 U.S. 992 (1993); *MBNA Am. Bank*, 640 S.E.2d 226, cert. denied, *FIA Card Servs., N.A. v. Tax Comm'r*, 127 S. Ct. 2997 (2007). A decision to deny *certiorari* is, of course, not a decision on the merits.

193. See MICH. COMP. LAWS ANN. § 208.1203(3) (West Supp. 2007).

194. MICH. COMP. LAWS ANN. § 208.1303(3) (West Supp. 2007).

195. *Id.*

196. See *Complete Auto Transit*, 430 U.S. 274.

197. See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

apportionment of particular gross receipts taxes is required.¹⁹⁸ It also has sustained some unapportioned gross receipts taxes in certain early cases on grounds that seem to elevate form over substance.¹⁹⁹

The Michigan MGRT is apportioned using a “sales only” apportionment formula.²⁰⁰ “Sales” in this context includes gross receipts not only from sales transactions, but also from many other transactions as well.²⁰¹ This broad definition of sales is consistent with the uniform practice of states in apportioning income under their corporate income taxes.²⁰²

Michigan’s use of an apportionment formula for its MGRT is unquestionably a constitutional requirement, notwithstanding the lack of clarity in the Court’s position generally on the apportionment of gross receipts taxes. The reason is that the unapportioned tax base explicitly includes the proceeds of sales and other transactions having no plausible nexus with Michigan, such as a good produced and sold outside of Michigan.²⁰³ Under the U.S. Constitution, “some definite link, some minimum connection”²⁰⁴ must exist between Michigan and the activities generating the modified gross receipts that the State seeks to tax.²⁰⁵ A further condition is that a rational relationship must exist between the tax base and the activities conducted within Michigan.²⁰⁶ The State can tax only those modified gross receipts that are fairly attributable to activities in Michigan.²⁰⁷ These constitutional requirements would be violated without some form of apportionment. Moreover, without apportionment, the tax would be internally inconsistent—that is, it would necessarily produce double taxation if adopted by the other states.²⁰⁸

198. See *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948).

199. See, e.g., *General Motors Corp. v. Washington*, 377 U.S. 436 (1964), *overruled in part by Tyler Pipe*, 483 U.S. 23; *Standard Pressed Steel Co. v. Dep’t of Revenue*, 419 U.S. 560 (1975).

200. MICH. COMP. LAWS ANN. § 208.1303 (West Supp. 2007).

201. MICH. COMP. LAWS ANN. § 208.1305 (West Supp. 2007).

202. See, e.g., UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT (UDITP) § 1(g) (1957), available at http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69/udiftp-57.htm (last visited June 29, 2008) (“‘Sales’ means all gross receipts of the taxpayer not allocated under sections 4 through 8 of this Act.”).

203. See MICH. COMP. LAWS ANN. § 208.1203(3) (West Supp. 2007).

204. *Miller Bros. v. Maryland*, 347 U.S. 340, 344-345 (1954).

205. See *id.*

206. See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983).

207. *Complete Auto Transit*, 430 U.S. at 279; *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425, 436-37 (1980).

208. The internal consistency doctrine was formulated by the Court on its own in *Container*, 463 U.S. at 169. “The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than [100% taxation].” *Id.* *Container* also formulated the external consistency test. “The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how

The gross receipts taxes that have been upheld by the Court generally have been ones that the Court could formally describe as imposing burdens only on activities conducted within the taxing jurisdiction. For example, Washington's gross receipts tax²⁰⁹ on wholesaling within the State was upheld because the wholesaling activity took place there, even though the goods were produced elsewhere.²¹⁰ Although the Court was content with the fact that the wholesaling took place in Washington, the economic reality was that the tax was imposed on gross receipts that were attributable in part to the manufacturing that occurred elsewhere; hence, Washington was in effect taxing values generated outside the State.²¹¹ We have criticized the Court upholding Washington's gross receipts tax on the wholesaling of goods in the State that were manufactured elsewhere as reflecting the type of formalistic reasoning that the Court claims to have foresworn after the transformation of its dormant Commerce Clause jurisprudence in the *Complete Auto* era.²¹² We have also argued that this line of reasoning should not survive the Court's decision in *Oklahoma Tax Commissioner v. Jefferson Lines*.²¹³ A number of state courts have subsequently agreed.²¹⁴

We have suggested in Section II.B above, that the Michigan MGRT is best understood as a modified sales-subtraction VAT. So viewed, the tax is directed at taxing consumption within Michigan. To achieve that result, apportionment under a sales-only formula is appropriate. Otherwise, the MGRT would tax consumption in every state of taxable goods and services sold by any taxpayer having nexus with Michigan. Such a tax would be nonsensical from a policy perspective. It also would be unquestionably unconstitutional.

income is generated." *Id.* For the reasons discussed in the text, if the MGRT were unapportioned, it would also violate the Court's external consistency requirement.

209. WASH. REV. CODE ANN. §§ 82.04.010-.900 (West 2006).

210. *See generally* Tyler Pipe v. Washington, 483 U.S. 232 (1987).

211. *See id.* at 251 ("The activity of wholesaling—whether by an in-state or out-of-state manufacturer—must be viewed as a separate activity conducted wholly within Washington that no other State has jurisdiction to tax.").

212. *See* Hellerstein, McIntyre, & Pomp, *supra* note 49, at 95-97.

213. 514 U.S. 175 (1995). *See* Hellerstein, McIntyre, & Pomp, *supra* note 49, at 97-102. In *Jefferson Lines*, the Court characterized a gross receipts tax as "simply a variety of a tax on income, which was required to be apportioned to reflect the location of the various interstate activities by which it was earned." *Jefferson Lines*, 514 U.S. at 190. Income taxes on cross-border activities must be apportioned.

214. *See, e.g.,* Northwood Constr. v. Twp. of Upper Mooreland, 856 A.2d 789 (Pa. 2004), *cert. denied*, 125 S.Ct. 1736 (2005) (municipal business privilege tax); Ford Motor Co. v. City of Hazelwood, No. 02CC-00296 (Mo. 21st Cir. Ct. Aug. 26, 2003) (city gross receipts tax); Philadelphia Eagles Football Club, Inc. v. City of Philadelphia, 823 A.2d 108 (Pa. 2003) (city business privilege tax); M & Assoc., Inc. v. City of Ironton, 723 So.2d 592 (Ala. 1998) (city license tax); City of Winchester v. American Woodmark Corp., 471 S.E.2d 495 (Va. 1996) (city business professional and occupational license tax). *But see* Ford Motor Co. v. City of Seattle, 156 P.3d 185 (2007), *cert. denied*, 128 S.Ct. 1224 (2008).

The MGRT, as well as the business income tax, require certain taxpayers engaged in a unitary business to compute their tax on the basis of a combined report.²¹⁵ The constitutionality of combined reporting in the context of a corporate income tax is beyond doubt.²¹⁶ We see no reason why the extension of the rule to the MGRT should present any new constitutional issues. The basic constitutional issue is nexus—once that is established, the particular tax imposed would seem to be irrelevant.²¹⁷

One constitutional issue that is relevant for both the Michigan business income tax and the MGRT arises from Michigan's adoption of its water's edge rule, discussed in Section III.C.2, below. In general terms, Michigan excludes from its definition of a unitary business group all foreign persons and a few domestic persons engaged primarily in foreign business activities.²¹⁸ A constitutional issue may arise if the water's edge system gives a more favorable result for U.S. persons than for foreign persons. In that event, an argument might be made that the rule violates the Foreign Commerce Clause. California, like some other states, addresses the issue by making its water's edge regime elective.²¹⁹ Those not making the election are required to include all participants in the unitary business, foreign and domestic, in the unitary business group.²²⁰

2. Defining a Michigan Sale

Every state having a corporate income tax includes sales as one of the apportionment factors.²²¹ As a result, all of these states have adopted rules for determining when a sale occurs within their jurisdiction. The rules typically differ, however, depending on the nature of the goods or services sold.²²² The Multistate Tax Commission (MTC) has developed regulations providing guidance on the issue.²²³

215. MICH. COMP. LAWS ANN. § 208.1511 (West Supp. 2007).

216. *See generally* *Container*, 463 U.S. at 159; *Barclays Bank v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

217. *See generally* McIntyre, *supra* note 156 (arguing that a corporation should not be able to avoid nexus for sales and use tax purposes by isolating nexus-creating assets and activities in an affiliated company that is a member of its unitary group).

218. MICH. COMP. LAWS ANN. § 208.1117(6) (West Supp. 2007).

219. CAL REV & TAX CODE § 25110(a) (West 2008).

220. For discussion of the constitutional problems arising from excluding foreign corporations from the combined report, *see* McIntyre, Mines, & Pomp, *supra* note 37, at 734.

221. *See, e.g.*, CAL REV & TAX CODE § 25128(a) (West 2004).

222. *See, e.g.*, UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT (UDITPA) §§ 16-17 (1957), available at http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69-udiftp57.htm (last visited June 29, 2008).

223. Allocation and Apportionment Regulations, IV.16-18, MULTISTATE TAX COMMISSION (2007), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_-

The Michigan Business Tax provides rules for determining the location of sales that do double duty—they determine the location of sales both for the business income tax and for the MGRT.²²⁴ The rules are reasonably detailed, primarily to take account of the variety of different types of businesses subject to the two taxes. The rules dealing with the sale of tangible personal property and the sale of services are addressed below.

a. Locating a Sale of Tangible Personal Property

UDITPA provides that a sale of tangible personal property is assigned to a particular state if, *inter alia*, “the property is delivered or shipped to a purchaser within this state.”²²⁵ The MTC regulations interpret UDITPA to mean that “property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.”²²⁶ The MGRT starts off with the UDITPA rule, but adds a significant wrinkle. It provides:

Sales of tangible personal property are in this state if the property is shipped or delivered, or, in the case of electricity and gas, the contract requires the property to be shipped or delivered, to any purchaser within this state *based on the ultimate destination at the point that the property comes to rest* regardless of the free on board point or other conditions of the sales.²²⁷

The objective of the italicized language above is unclear. Under one reading, the point is simply to exclude from Michigan sales those goods that are delivered to a Michigan purchaser merely for transshipment elsewhere. The classic example is a so-called dock sale. This category describes a customer that takes delivery at the vendor’s shipping dock using its own trucks or, alternatively, a common carrier. If the vendor can substantiate that the goods are taken out-of-state, the sale will not be viewed as occurring in-state.²²⁸

Dock sales involve outbound situations. The parallel situation involving inbound sales would be if a firm in New York trucks goods to a purchaser’s warehouse in Michigan, and the goods are then transferred by the purchaser to another truck and taken to Illinois. In that case, the

Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocationandApportionment-Reg.pdf [sic] (last visited June 29, 2008).

224. MICH. COMP. LAWS ANN. § 208.1111 (West Supp. 2007) (defining gross receipts for purposes of the Michigan Business Tax).

225. See UDITPA § 16, *supra* note 222.

226. MTC Reg. IV.16 (a)(3) (1973), *supra* note 223.

227. MICH. COMP. LAWS ANN. § 208.1305(1)(a) (West Supp. 2007) (emphasis added).

228. POMP & OLDMAN, *supra* note 8, at 10-17.

transit in Michigan should not attract a tax provided the New York firm can document the transshipment. As applied to these examples, the rule makes good sense. It may also further the attractiveness of Michigan as a place to store temporarily goods from out-of-state that are destined for shipment elsewhere.

A second reading, consistent with the first, is that sales of goods shipped and delivered outside of Michigan will be treated as Michigan sales if the ultimate destination is Michigan. This rule can be understood as an anti-avoidance rule. For example, if a New York firm ships goods to a Michigan customer only as far as Toledo, Ohio, and the customer picks up the goods there for transport to Michigan, the sale should be characterized as a Michigan sale, assuming the vendor documents that the goods actually were transported to Michigan.

Under a third reading, sales of goods would constitute non-Michigan sales if the goods are delivered to a purchaser in Michigan and come to rest in Michigan without any transshipment plan (which distinguishes this case from the dock sales discussed above), and then those goods are later resold to purchasers who take the goods outside the State. The MTC regulation explicitly rejects that position.²²⁹ It provides that goods delivered to a state are treated as in-state sales if the shipment terminates in the state even if the goods are ultimately delivered to a purchaser outside the state.²³⁰

The first two readings of the statute require the vendor to know the place where the purchaser is ultimately shipping the goods. If the purchaser is cooperative, the place of ultimate shipment is knowable. The third reading, if actually intended by the Legislature, presents more troubling problems. Treating goods ending up outside the State as non-Michigan sales would be correct in principle if the goal of the MGRT were to exempt goods consumed out-of-state, as we suggested in Section II.B above. But doing so is not easy.

Consider, for example, a Michigan grocer store selling food at retail to its customers. Some customers may have driven from Ohio, purchased groceries, and taken them back to Ohio. Is the grocer expected to know this fact? Is the grocer expected to ask customers where they plan to consume the goods? The same problem exists for retailers operating in a shopping mall located within driving distance of the Ohio, Ontario, Indiana, or Wisconsin borders. Not even the Michigan retail sales tax requires retailers to ascertain the ultimate destination of the goods they sell over the counter.

229. The MTC sets forth an example providing that a “taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of the taxpayer’s products shipped to the purchaser’s warehouse in this state constitute property delivered or shipped to a purchaser within this state.” MTC Reg. IV.16.(a)(3), *supra* note 223.

230. *See id.*

A similar problem arises from sales to distributors or wholesalers and sales of goods to producers that incorporate those goods into their products. Even if the purchaser were willing to share proprietary information about its customers with the Michigan seller, the purchaser may not know in the year of the sale where such goods will ultimately come to rest. The goods may not have been resold at the time that the seller has to file its MGRT return. Or the goods may have been resold to yet another distributor or wholesaler. If the goods sold were incorporated into new products, it would be unreasonable, if not impossible, for the original seller to learn from its purchaser/producer the destination of those new products.

An additional complication arises if the purchaser has resold only some of the goods previously purchased from the Michigan seller. In that case, some accounting convention, such as LIFO or FIFO, would be needed to determine which of the goods were sold and which still remain in inventory. As this brief discussion suggests, these administrative complications argue against the third interpretation of the statute.

Of course, the problem of administering an exception for goods ultimately shipped outside the State is not so difficult for sales of certain goods, such as automobiles, boats, or planes, which have to be registered. If the point is to have a special rule for such sales, however, the Michigan Legislature should have said so.

b. Locating a Sale of Services

UDITPA provides that:

[s]ales, other than sales of tangible personal property, are in this state if: (a) the income-producing activity is performed in this state; or the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.²³¹

That so-called cost of performance rule may be acceptable for an income tax, which is intended to tax income attributable to in-state activities, but it may not be the best rule in the Michigan MGRT, which may be seen as a tax intended to reach consumption within the state.

The MGRT provides the following rule for determining the location of services:

231. UDITPA § 17, *supra* note 222. The MTC regulations interpreting section 17 are found in MTC Reg. IV.17, but are irrelevant to the discussion in the text. *See* MTC Reg. IV.17, *supra* note 223.

Except as otherwise provided in this section, all receipts from the performance of services are included in the numerator of the apportionment factor *if the recipient of the services receives all of the benefit of the services in this state*. If the recipient of the services receives some of the benefit of the services in this state, the receipts are included in the numerator of the apportionment factor in proportion to the extent that the recipient receives benefit of the services in this state.²³²

This rule may be correct in principle, on the assumption that the purpose of the MGRT is to tax consumption enjoyed within Michigan. Unfortunately, it is totally unworkable. An individual goes into a barbershop for a haircut just before going on a long trip outside the State. Is the barber expected to ascertain whether the customer will receive all of the benefits of the hair-cutting service within Michigan? Barbers typically are chatty people, but are they now required to be chatty in order to comply with the tax laws? What about automobile repair services? Is the customer going to be asked for a breakdown of in-state and out-of-state travel plans? Is the auto mechanic responsible for checking if those plans come to fruition?

In administering its gross receipts tax, the Ohio Commercial Activities Tax (CAT), the Ohio Department of Taxation has provided guidance on the location of gross receipts from services.²³³ To say these voluminous rules are “detailed” would be a major understatement. In general, the CAT regulations assign services to Ohio if the services are delivered at retail in Ohio. For example, veterinarian services performed in Ohio are located exclusively in Ohio, even if the pet owner is a nonresident.²³⁴ Towing services are located in Ohio if the services originate in Ohio, regardless of the destination of the vehicle being towed.²³⁵ The same “delivery” rule applies to repair services if the goods to be repaired are left off and picked up at a repair shop located in Ohio, notwithstanding they are immediately removed from the State.²³⁶ Services obtained at a barber shop, beauty salon, or spa are located exclusively in Ohio if the services are performed at an Ohio location, even if the customer lives outside Ohio.²³⁷

232. MICH. COMP. LAWS ANN. § 208.1305(2)(a) (West Supp. 2007) (emphasis added).

233. See OHIO ADMIN. CODE § 5703-29-17 (West 2008) (discussing the siting of certain services for purposes of the commercial activity tax). The Ohio tax is fundamentally different from the MGRT. Ohio taxes only services that are situated to that State. See *id.* It does not use an apportionment formula to make that determination. Instead, as discussed in the regulation, it has an elaborate set of rules for determining the situs of services. See *id.*

234. See OHIO ADMIN. CODE § 5703-29-17(c)(53) (West 2008).

235. See OHIO ADMIN. CODE § 5703-29-17(c)(50) (West 2008).

236. See OHIO ADMIN. CODE § 5703-29-17(c)(44) (West 2008).

237. See OHIO ADMIN. CODE § 5703-29-17(c)(8) (West 2008).

The situs rules found in Ohio's CAT regulations may provide the Michigan tax authorities with a useful starting point in specifying the location of gross receipts from the sale of services. The Ohio rules do not pretend to ascertain where the benefits of services are ultimately obtained. They are practical rules that generally locate services in Ohio if that State is the jurisdiction best able to impose the tax. Michigan is going to be compelled to make similar compromises with consumption-tax principles in order to administer the MGRT successfully.

Locating sales of intermediate services presents new difficulties. The apparent objective of the MGRT statute is to locate services in the state where the consumption benefits of the services are enjoyed. Intermediate goods, almost by definition, are not consumed anywhere. Instead, they are incorporated into some final good or service, and it is that final good or service that is consumed. The service provider cannot be expected to ask the purchaser to keep track of those services until the ultimate consumer enjoys them. In many ways, the problem is similar to determining the ultimate destination of tangible personal property, discussed in Section III.C.1, above.

Michigan will need to develop practical rules that establish the location of intermediate services. The touchstone for those rules cannot be the place of consumption because intermediate services are not consumed by the purchaser. Ohio, in its CAT regulations, seems to have moved toward a place of use test in the majority of cases involving intermediate services; although, it also uses other tests, including place of performance. Michigan probably will have to use multiple tests, each designed to simplify administration and limit opportunities for tax avoidance and evasion. A place of use test, however, is probably a good place to start in developing workable rules.

D. Unitary Business Concept in the Context of an Adjusted Gross Receipts Tax

In accordance with best tax practices, Michigan has adopted a combined reporting system both for its business income tax and for the MGRT. Under combined reporting, related taxpayers engaging in a unitary business are treated in some respects as if they were a single taxpayer, with transactions within the unitary business group eliminated in determining net income subject to apportionment.²³⁸ The income of the unitary business group is then apportioned by formula to each state in which members of the group are conducting business.²³⁹ In recent years, Massachusetts (2008), New York (2007), Texas (2006) Vermont (2004) and West Virginia (2007) have adopted a combined-reporting rule,

238. See, e.g., MICH. COMP. LAWS ANN. § 208.1511 (West Supp. 2007).

239. See, e.g., CAL REV & TAX CODE § 25128(a) (West 2004); MICH. COMP. LAWS ANN. §§ 208.1301(1), (3) (West Supp. 2007).

joining California and fifteen other states, which have used the rule successfully for decades.²⁴⁰ In this respect, Michigan is joining an emerging trend among the states towards combined reporting. Michigan also is breaking new ground because the Michigan business income tax and the MGRT apply to all business firms, not just corporations, and its combined-reporting rule extends to qualified business firms, however organized, that are engaged in a unitary business.²⁴¹

Tax specialists have promoted combined reporting for many years as an effective method for fairly apportioning the tax base of a corporate income tax and for combating certain forms of aggressive tax avoidance.²⁴² We will not reprise that literature here or discuss the various arguments, pro and con, for implementing a combined-reporting rule for the Michigan business income tax. We limit ourselves here to briefly describing Michigan's rules for applying combined reporting to the MGRT and discussing some special issues.

A combined reporting regime applies to all relevant firms engaged in a unitary business in the state, whether or not a particular member of what Michigan refers to as the "unitary business group"²⁴³ has substantial nexus with the state as a result of its own activities in the state.²⁴⁴ Michigan has adopted the majority rule and has rejected what is known as "nexus combination."²⁴⁵ Under the nexus combination rule, only those members of the unitary business group that have independent nexus with the state are included in the combined report. Under the Michigan rule, which we strongly endorse and which the U.S. Supreme Court has approved, a combined report is required to be filed if any member of the unitary group meets the substantial nexus standard.

240. See Michael Mazerov, *State Corporate Tax Shelters and The Need for "Combined Reporting,"* CENTER ON BUDGET AND POLICY PRIORITIES (Oct. 26, 2007), available at <http://www.cbpp.org/10-26-07sfp.htm> (last visited May 8, 2008).

241. See MICH. COMP. LAWS ANN. § 208.1117(6) (West Supp. 2007).

242. For our joint contribution to that literature, see McIntyre, Mines, & Pomp, *supra* note 37. See also Michael J. McIntyre, *The Use of Combined Reporting by Nation States,* in *THE TAXATION OF BUSINESS PROFITS UNDER TAX TREATIES* (Arnold, Sasseville, & Zolt, eds. 2003), revised and reprinted in 35 *TAX NOTES INT'L* 917-48 (Sept. 6, 2004).

243. The MBT defines a unitary business as:

a group of United States persons, other than a foreign operating entity, one of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.

MICH. COMP. LAWS ANN. § 208.1117(6) (West Supp. 2007).

244. See MICH. COMP. LAWS ANN. § 208.1511 (West Supp. 2007). For a general discussion, see McIntyre, Mines, & Pomp, *supra* note 37.

245. Nexus combination is criticized in POMP & OLDMAN, *supra* note 8, at 10-38-10-39.

The MGRT provides that members of a unitary business group are required to eliminate all intra-group transactions in computing their tax liability.²⁴⁶ This rule determines both the base of the tax and the numerator and the denominator of the sales-only apportionment formula. Eliminating transactions between related persons prevents members of a unitary business group from using inappropriate transfer prices to inflate their deduction for purchases from other firms or from minimizing the amount of their sales.

Because almost all sales between related persons are sales of intermediate goods and services, removing those sales eliminates the need to determine their location. Given the problems discussed above in determining the location of intermediate sales, eliminating them from the tax base and from the apportionment formula should reduce administrative problems both for tax administrators and for taxpayers that are members of a unitary business group.

Membership in a unitary business group is limited to U.S. persons.²⁴⁷ Foreigners need not apply. The exclusion of some or all foreign persons from the unitary group is popularly referred to as a “water’s edge” rule. Water’s edge rules vary from state to state. Some states do as Michigan has done and simply provide that only U.S. persons (or only persons filing Federal consolidated returns, or that can file such returns) can be members of a unitary business group.²⁴⁸ Other states, notably California, would include certain “tax haven” foreign corporations in the elective water’s edge group to prevent tax avoidance.²⁴⁹ As noted in Section III.C.1, above, limiting membership in the unitary business group only to U.S. persons may present constitutional difficulties. That rule also offers

246. See MICH. COMP. LAWS ANN. § 208.1511 (West Supp. 2007).

247. See MICH. COMP. LAWS ANN. § 208.1117(6) (West Supp. 2007).

248. States that generally require unitary business groups to file a combined report only for their domestic members (or members filing a Federal consolidated return) include Arizona, A.R.S. § 43-947(E) (2008) (providing that only taxpayers entitled to file a Federal consolidated return may file an Arizona consolidated return); Hawaii, HRS § 235-92(2) (2008) (“For each taxable year, returns shall be made by . . . Every corporation having for the taxable year gross income subject to taxation under this chapter; provided that an affiliated group of domestic corporations may make and file a consolidated return for the taxable year . . .”); Kansas, K.S.A. § 79-32,142(b) (West 2006) (“any affiliated group means any group of corporations permitted to file a consolidated return for federal income tax purposes”); Minnesota, MINN. R. 8019.0405 (2007) (“While a foreign corporation may be part of a unitary business, only domestic corporations . . . can file a combined report.”). Under Int. Rev. Code §§ 1504(b)(3), (d), only U.S. corporations or certain real estate holding companies organized in Canada or Mexico can file consolidated returns.

249. For a detailed discussion of the California rules and suggestions on how best to design a water’s edge system, see McIntyre, Mines, & Pomp, *supra* note 37, at 732-38. One improvement on the Michigan rule would be to include foreign entities in the combined group if they have over 20% of their business activity in the United States. See, e.g., 35 ILL. COMP. STAT. ANN. 5/1501(a)(27) (West 2008) (defining “unitary business group” to exclude those members whose business activity outside the United States is 80% or more of any such member’s total business activity . . .”).

some avenues for tax avoidance. For example, a rule limiting the unitary business group to U.S. entities would allow taxpayers to avoid Michigan tax by deflecting gross receipts to a foreign holding company or a foreign company with minimal business activities. At a minimum, the tax authorities should be given the authority to include foreign entities in a unitary business group if inclusion is necessary to prevent abusive tax avoidance.²⁵⁰ The tax authorities also should have explicit authority to treat any entity as a domestic entity if it is so treated for federal tax purposes.

In addition to excluding foreign persons, the Michigan water's edge rule also excludes certain U.S. persons identified as foreign operating entities.²⁵¹ A U.S. person qualifies for this classification if it has "substantial operations outside the United States, the District of Columbia, the Commonwealth of Puerto Rico, [or] any territory or possession of the United States," and "at least 80% of its income is active foreign business income"²⁵² This rule can present taxpayers with opportunities for tax avoidance. It should be modified to allow the tax authorities to require the inclusion of a U.S. company in the unitary business group when necessary to prevent abusive tax avoidance.

IV. CONCLUSION

Michigan, which was a tax pioneer with its Single Business Tax, is again a pioneer among the states in adopting its modified gross receipts tax (MGRT). In contrast to a genuine gross receipts tax, such as the Washington B&O tax or the Ohio Commercial Activities Tax (CAT), the MGRT allows a deduction for purchases from other firms. By allowing that deduction, the MGRT operates like a value-added tax, which is generally thought to be primarily a tax on consumers rather than on businesses. As discussed above, the classification of the MGRT is not free from ambiguity. Still, its classification as a sales-subtraction value-added tax strikes us as appropriate.

Assuming that the MGRT operates as a consumption tax that is passed on to consumers on their purchases of good and services, one might wonder why the Michigan Legislature did not simply increase the rate of the existing retail sales tax from 6% to around 7%. That step undoubtedly would have been a lot simpler because the adoption and implementation of a brand new tax is no easy matter. Two independent political reasons might explain the legislative choice.

250. For discussion of WalMart's use of a foreign entity to defeat Illinois's combined reporting regime, see Jesse Drucker, *Why WalMart Set Up Shop in Italy*, WALL ST. J., Nov. 14, 2007 at C1.

251. See MICH. COMP. LAWS ANN. § 208.1117(6) (West Supp. 2007).

252. MICH. COMP. LAWS ANN. § 208.1109(5) (West Supp. 2007). Active foreign business income is defined in I.R.C. § 861(c)(1)(B) (2008).

First, the Michigan Constitution limits the state sales tax rate to 6%.²⁵³ A constitutional amendment could solve that problem, but such an amendment certainly could not have been adopted in time to deal with the State's budget problems created by the repeal of the Single Business Tax. It might not have been adopted at all, given the hostility of many Michigan voters to tax increases.

Second, the apparent political necessity was that the tax replacing the Single Business Tax be perceived as a tax on business, not on consumers. Whatever the likely economic impact of the MGRT on price levels, it generally has been perceived by the population as a business tax, not a sales tax. Even the businesses required to remit the tax acted as if the tax was on them rather than on their customers.

Although the Michigan sales and use tax and the MGRT can both be viewed as taxes on consumption, the base of the MGRT is substantially broader than that of the sales and use tax. The Michigan sales and use tax applies to most Michigan sales of tangible personal property. There are some notable exceptions, however, for items such as food and pharmaceutical drugs. It taxes a rather short list of services. The MGRT taxes everything covered under the retail sales tax plus a lot more. Unlike the sales tax, no exemption exists for the sale of food or medicines, or even for medical or dental services. Virtually all services are taxable as long as the provider has gross receipts over \$350,000. Indeed, some services that constitute business inputs are subject to a double tax. This tax on services was enacted with none of the hoopla that accompanied the efforts of the Governor and the Legislature to expand the base of the sales tax to include services. We assume that part of the reason is the low rate, but a major part is likely to be that the tax is not being viewed as a tax on the consumer of goods and services.

One of the apparent flaws in the MGRT, when viewed as an attempt to tax consumption, is that it generally does not allow a deduction for the purchase of services used in a business. The result is that such services may be taxed twice—once when sold by the producer to a business firm and then again when the purchasing firm sells the output embodying those services. For example, assume that BCo manufactures books in Michigan and sells them to Michigan customers. It hires ACo, an independent Michigan firm, to attach the book bindings. ACo's sales of the binding services are taxable under the MGRT, and BCo is not allowed a deduction. The cost of the binding services presumably is included in the price of the books, so that the binding services are taxed again when the books are sold.

The misclassification of the MGRT as a tax on businesses may not be harmless error. The Single Business Tax, although often described by tax specialists as a form of value-added tax, was apparently viewed by the public and by the businesses remitting the tax as a peculiar, irksome,

253 MICH. CONST. art. IX, § 8 (1963).

even irrational business tax. The inclusion of wages in the tax base, although appropriate for an addition-method value-added tax, was roundly criticized by business interests and castigated in the political arena as a jobs killer. The fact that the tax had to be paid whether or not the firm remitting the tax was profitable was a planned benefit of the tax; yet, this feature was widely criticized by those who viewed the SBT as a flawed tax on business profits. Comparable unwarranted criticisms of the MGRT are entirely possible. At the same time, the flaws in the tax, such as its double taxation of services that constitute business inputs, may go unnoticed in the political arena as a result of the erroneous classification.

The Governor and Legislature undoubtedly hope that the MGRT will contribute to the economic development of Michigan. As noted above, the new tax is a decided improvement from an economic-development perspective over the SBT in its treatment of imports and exports. It generally taxes the value added attributable to imports and does not tax the value added attributable to exports, whereas the opposite was true of the SBT for most of its history.

As with just about any tax, the incidence of the MGRT is not entirely clear. If we accept the assumption by most economists that under typical economic conditions the tax imposed by a VAT will be shifted partially or fully forward to consumers, then it is reasonable to assume the same result for the MGRT. Although the MGRT differs in the mode of collection from the credit-subtraction VATs found in Canada, Europe, and most other countries, it still has most of the features of a VAT.

A tax on consumers is not necessarily good for economic development. That is, one should not assume that a tax advances economic development merely because the tax is popular with business interests. Most countries that have been successful economically have created a strong market for their businesses through the fostering of a prosperous middle class. Hammering the middle class with heavy taxes on consumption is not only unfair—it may also be detrimental to economic development.

That said, the economic effects of the new tax are not likely to be substantial. With a rate under 1% and most cascading effects eliminated, the MGRT surely does not lay a heavy tax on consumers even if they are its real taxpayers. The broad scope of the tax (in terms of the firms included and the goods and services covered), coupled with the low rate, will prevent the tax from having significant effects on business choices, although the double tax on certain services is cause for some concern. In the end, the major benefit of the MGRT will probably be that it provides Michigan with a stable and relatively neutral source of revenue. In our view, a state cannot expect to project a positive image to investors if it is having well publicized problems, year after year, in paying its bills.