STATE OF MICHIGAN
DEPARTMENT OF ENERGY, LABOR & ECONOMIC GROWTH
MICHIGAN TAX TRIBUNAL

Larry J. Winget & Alicia J. Winget,
Petitioners,

v MTT Docket No. 319852

Department of Treasury, Tribunal Judge Presiding
Respondent. Cynthia J Knoll

FINAL OPINION AND JUDGMENT

The Tribunal, having given due consideration to the file in the above-captioned case, finds:

1. Administrative Law Judge (ALJ) Thomas A. Halick issued a Proposed Opinion and Judgment on December 15, 2009. The Proposed Opinion and Judgment states, in pertinent part, "[t]he parties have 20 days from date of entry of this Proposed Opinion and Judgment to file exceptions and written arguments with the Tribunal consistent with Section 81 of the Administrative Procedures Act (MCL 24.218). The exceptions and written arguments shall be limited to the stipulated facts."

2. On January 4, 2010, Respondent filed exceptions to the Proposed Opinion and Judgment. In the exception, Respondent states:

   a. "Treasury does not take exception to the ruling or reasoned decision of Administrative Law Judge Thomas A. Halick. Treasury makes a limited exception to the use of the term *unitary* when related to Section 102 of the Michigan Individual Income Tax Act. Specifically, Administrative Law Judge Halick states on pages 15 and 16 as follows:

      > Section 102 applies to 'income-producing activities' of a particular entity. The 'income-producing activities' of the S corporation *are* the taxpayer's activities. It follows that the 'taxable income' of a taxpayer must relate to the 'income-producing activities' of that taxpayer. The statute refers to 'the entire taxable income of such taxpayer,' which means the taxpayer's entire income from the 'income-producing activities' that are confined to this state. 'Income-producing activities' refers to *unitary* business activities. This section applies to the income and business activity of the 100% Michigan companies in this case, whose income-producing activities were confined to Michigan, as indicated on Exhibits R3 and R8. Section 102 plainly refers to a taxpayer whose activities are confined to this state, and there is no indication that 'income-producing activities' of other entities should be considered when determining whether the income produced from

> ‘Activity confined solely [to] this state’ should be subject to apportionment.” (Emphasis in original.)

b. “Treasury takes limited exception to the use of ‘unitary’ in the sentence: ‘Income producing activities’ refers to *unitary* business activities.’ Section 102 requires allocation of business income if the activity takes place 100% in Michigan. The unitary business principle is an apportionment concept and does not have any application in the context of section 102 allocation. The use of ‘unitary’ may lead to confusion and it is suggested that the term ‘unitary’ be removed from the reference to section 102.” (Emphasis in original.)

3. Petitioners have not filed exceptions to the Proposed Opinion and Judgment or a response to Respondent’s limited exception.

4. The ALJ mistakenly included the sentence referring to *unitary* business activities in a discussion of Section 102, to which the *unitary* business principle is irrelevant. The Tribunal finds it appropriate to delete the word *unitary* from the second line of page 16.

5. Furthermore, the ALJ erred in regard to the unitary business principle (UBP) analysis. More specifically:

   a. The first issue in this appeal is whether the UBP applies to Michigan’s Income Tax Act. The Tribunal finds that the UBP is applicable to individuals under MITA section 115, which provides:

   > All business income, other than income from transportation services, shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.[2]

   b. The ALJ correctly determined that:

   “A state may only tax an apportioned share of income of a multistate business if that income arises from a *unitary* business activity with nexus to that state. *Allied-Signal, Inc v Director, Division of Taxation*, 504 US 768; 112 S Ct 2251; 119 L Ed 2d 533 (1992). The ‘unitary business principle’ is a constitutional limitation upon a state’s power to tax and has been called the ‘the linchpin of apportionability in the field of state income taxation.’ *Exxon Corp v Department of Revenue*, 447 US 207; 100 S Ct 2109; 65 L Ed 2d 66 (1980); *Mobil Oil Corp v Commissioner of Taxes*, 445 US 425, 439; 100 S Ct 1223; 63 L Ed 2d 510 (1980); and, *ASARCO, Inc v Idaho State Tax Commn*, 458 US 307; 102 S Ct 3103; 73 L Ed 2d 787 (1982). Therefore, no state may announce that it ‘does not follow’ the unitary business principle. Michigan’s income tax statutes must be interpreted in light of the constitutionally mandated unitary

[2] MCL 206.115

business principle. An interpretation that allows for a combination of apportionment factors of **non-unitary businesses** cannot stand and is contrary to Michigan's apportionment statutes." (Proposed Opinion and Judgment, p. 22.)

c. The issue raised in this case relates to apportionment of Petitioners' business income and whether or not the total distributive share of business income from S corporations must be apportioned based on the combined apportionment factors of the business entities that generated the income. The Tribunal finds that if some or all of the entities were found to constitute a unitary business, the UBP applies and the combined business income must be apportioned accordingly. This is not to say that combined reporting is required or even permitted, but rather the apportioned income of the taxpayers would be determined based on the UBP.

d. The ALJ was correct in finding that:

"With regard to all of the entities at issue, other than generalized testimony that they were engaged in automotive related businesses, there are no facts to support a conclusion that the entities constitute a 'unitary' business. This suggests that even under the theory pursuant to which the original return was filed (excluding income and losses of non-unitary businesses) the factors should be combined only for those entities that are together engaged in a unitary business. However, the facts do not support a conclusion that they were so engaged." (Proposed Opinion and Judgment, p. 29.)

e. The ALJ was incorrect in stating:

"It must be emphasized that the discussion of the unitary business principal in this opinion does not imply that combination of the factors would be permitted or required even if Petitioners had plead and proved that some or all of the entities were engaged in a unitary business. It does not violate the unitary business principle to consider each entity separately for apportionment purposes. Petitioners have failed to prove that combining the factors would be consistent with the unitary business principle or the Michigan Income Tax Act." (Proposed Opinion and Judgment, p. 33.)

The above paragraph shall be stricken from the Final Opinion and Judgment.

f. Had Petitioners brought forth evidence of a unitary business enterprise for some or all of the S corporations, a different result may have been warranted.

6. Given the above, the Tribunal adopts the conclusion of the Proposed Opinion and Judgment finding Petitioners failed to prove that a unitary business existed between and amongst any of the S corporations. Therefore, Respondent was correct in determining Petitioners' taxable income is based on the business activities of each separate entity. Further, Respondent has shown good cause to justify the modifying of the Proposed Opinion and Judgment by striking the above-referenced sentence. As such, the Tribunal modifies the Proposed Opinion and

Judgment, as indicated herein, and adopts the modified Proposed Opinion and Judgment as the Tribunal's final decision in this case. See MCL 205.726. The Tribunal also incorporates by reference the Findings of Fact and Conclusions of Law contained in the Proposed Opinion and Judgment, as modified herein, in this Final Opinion and Judgment. Therefore,

IT IS ORDERED that Respondent's Final Assessment Nos. M393828 and M393829 are AFFIRMED.

IT IS FURTHER ORDERED that Respondent shall cause its records to be corrected to reflect the taxes, interest, and penalties, as finally shown in the Final Opinion and Judgment within 20 days of entry of this Final Opinion and Judgment.

IT IS FURTHER ORDERED that Respondent shall collect the affected taxes, interest, and penalties or issue a refund as required by this Order within 28 days of entry of this Final Opinion and Judgment.

MICHIGAN TAX TRIBUNAL

By Cynthia J Knoll

Entered: January 5, 2011
sms

STATE OF MICHIGAN
STATE OFFICE OF ADMINISTRATIVE HEARINGS AND RULES

Larry J. and Alicia J. Winget

Petitioners,

v

Michigan Department of Treasury,

Respondent.

MICHIGAN TAX TRIBUNAL
MTT Docket No. 319852

Administrative Law Judge Presiding
Thomas A. Halick

PROPOSED OPINION AND JUDGMENT

ORDER GRANTING JOINT MOTION FOR PROTECTIVE ORDER

A hearing was held April 29, 2009, on Petitioners' appeal of assessments of individual income tax imposed upon the apportioned, distributive share of income from various subchapter S corporations of which Petitioner Larry J. Winget was the sole or majority shareholder. The parties presented documentary evidence and testimony. Counsel presented legal arguments and filed post hearing briefs. This proceeding is original, independent, and *de novo*. MCL 205.735(1). The Tribunal holds that the final assessments are affirmed as follows:

| **Assessment No.** | **Tax** | **Penalty** | **Interest*** |
|---|---|---|---|
| M393828 | $206,680.00 | $0.00 | $30,485.53 |
| M393829 | $710,768.00 | $0.00 | $75,621.82 |

*Interest continues to accrue per 1941 PA 122. Interest shown above is current as of the date of the assessments.

The following Exhibits were admitted into evidence by stipulation of the parties:

**Petitioners**

P1 – Corrected Final Assessment No. M393828

P2 – Corrected Final Assessment No. M393829

P3 – PWC Workpaper: Calculation of Combined Apportionment – 2002

P4 – Petitioners' MI-1040s and related Tax Returns for 2002 (Confidential filed under seal)

P5 – Petitioners' MI-1040s and related Tax Returns for 2001 (Confidential filed under seal)

P6 – Michigan Department of Treasury Letter, dated May 20, 2005, from Steven Hilker (Confidential filed under seal)

P7 – Department of Treasury Audit Workpapers

P8 – PWC Workpaper: Calculation of Combined Apportionment Formula -- 2001

**Respondent**

R1 – Petitioners' 2001 Michigan Individual Income Tax Return and associated schedules and Federal Returns (Confidential filed under seal)

R2 – withdrawn

R3 – 2001 worksheet as prepared by Respondent

R4 – Assessment Number (Corrected) M393828

R5 – Petitioners' 2002 Michigan Individual Income Tax Return and Associated Schedules and Federal Returns (Confidential filed under seal)

R6 – withdrawn

R7 – Letter to Larry J. and Alicia Winget dated May 20, 2005 (Confidential filed under seal)

R8 – 2002 worksheet prepared by Respondent

R9 – Assessment Number (Corrected) M393829

**Motion for Protective Order**

On the record, Petitioner and Respondent jointly moved for entry of a protective order and stipulated that Exhibits P4, P5, and P6 (also identified as R1, R5, and R7) contain confidential taxpayer information subject to MCL 205.28(1)(f) and information of a personal and confidential nature. Upon review of the above referenced exhibits, the ALJ rules that the documents at issue contain information of a personal nature that is protected from disclosure under the Freedom of Information Act, MCL 15.243(1)(a), and that there is no practicable method of redacting the confidential information. There is also no dispute that the documents contain information subject to MCL 205.28(1)(f). The identified Exhibits shall be kept in the Tribunal's file under seal and shall not be disclosed for any purpose other than as necessary for this proceeding or an appeal from an order of the Tribunal entered in this proceeding.

**Findings of Fact**

This section is a "concise, separate, statement of facts" within the meaning of MCL 205.751; and, unless stated otherwise, the matters stated or summarized are "findings of fact" within the meaning of 1969 PA 306, MCL 24.285. The facts of this case are largely undisputed.

Petitioners Larry J. Winget and Alicia J. Winget are the named Petitioners. They are domiciled in Michigan and are "residents" under MCL 206.18. Petitioner Larry J. Winget is a "taxpayer" within the meaning of the Michigan Individual Income Tax Act, MCL 206.26. During the years at issue, Mr. Winget was a shareholder of 17 subchapter S corporations who received "taxable income" as a distributive share from the S corporations as indicated on Exhibit P3 and P8. For the years at issue, Petitioners' taxable income included "business income" derived from multistate business activity.

The assessments at issue (Corrected Final Assessments M393828 and M393829) apply to the tax years 2001 and 2002, during which time Larry J. Winget ("Petitioner" or "Mr. Winget") was the sole shareholder of the S corporations referred to by the parties by the following names: Venture Leasing, Venture Industries, Vemco Inc., Vemco Leasing, Venture Mold, Venture Service, Experience Management, Venture Automotive, Venture Sales and Engineering, Venture Equipment Acquisition, Patent Holding, Venture Real Acquisition (2001 only), Venture Heavy Machinery, Modas, The Oaks Corporation, Oaks Golf Properties, Ohio Golf Courses, and Pacific Energy. Mr. Winget is a majority owner of Harper Properties.

Petitioners offered the testimony of Judy Caldwell, a Certified Pubic Accountant with the firm The Rehman Group, who testified that many of the companies are automotive related.

Ms. Caldwell testified that the apportionment of the business income for 2001, as indicated on Petitioners' Exhibit 8, was performed by the firm PriceWaterhouseCoopers ("PWC"). According to Ms. Caldwell, PWC determined that the apportionment factors of the entities should be combined, arriving at a total Michigan apportionment percentage of 41.59% and a non-Michigan percentage of 58.11%. PWC determined that three of the entities (The Oaks Corporation, Pacific Energy, and Ohio Golf Course Land Company) were "non unitary companies located in Ohio" and the factors related to those entities were not included in the combined apportionment factor. The income and losses of the "non unitary companies" were not included in the tax base (100% of the losses were added back to AGI, and 100% of the income was subtracted from AGI.) Ms. Caldwell testified that this was an error, and that the "Ohio" companies should have been included in the combined apportionment formula, and income and loss items should have been treated consistently with the other companies. The same method was used for 2002, as indicated by Petitioners' Exhibit P-8.

Venture Leasing and Venture Industries were engaged in multi-state business activities in 2001 and 2002. Vemco Inc. was engaged in multistate business activity in 2001 only. Petitioners' witness stated that the following 12 corporations were engaged in business activities solely in Michigan: Vemco Leasing, Venture Mold, Venture Service, Experience Management, Venture Automotive, Venture Sales & Engineering, Venture Equipment Acquisition, Venture Real Acquisition, Venture Heavy Machinery, Patent Holding, Harper Properties, and Modas. Respondent's Exhibits R-3 and R-8 also show these companies having an apportionment percentage of 100%, and there is no contrary evidence.

Petitioners' 2001 and 2002 income tax returns (MI 1040) were prepared by the firm of PriceWaterhouseCoopers ("PWC"). The focal point of this case is the apportionment method that PWC used to determine the "Michigan" tax base. As Petitioners phrase it, PWC used an "apportionment methodology at the 'taxpayer/shareholder level.'" The dispute arose when Respondent processed the returns and applied a different method of apportionment, which Petitioners characterize as apportionment "at the subchapter S corporation level." Respondent applied the apportionment factors of each S corporation to the income or loss of that same S corporation. This resulted in issuance of assessments of income tax against Petitioners.

The parties do not dispute the accuracy of the amounts reported for "sales," "property," and "payroll" attributable to the entities. The parties do not dispute that the income at issue is "business income" as defined by MCL 206.4(2), which generally means "…all income arising from transactions, activities, and sources in the regular course of the taxpayer's trade or business…."

**Petitioners' Contentions**

Petitioners' legal argument starts with the premise that "distributions from an S corporation are properly deemed income subject to apportionment." Petitioners' Post Hearing Brief, page 4. Because the Wingets engaged in multi-state activity through some of the subchapter S corporations, they are entitled to apportion all their business income received from the pass through entities "*at the taxpayer/shareholder level*." [Emphasis added]. When Petitioners use the phrase "*at the taxpayer/shareholder level*" they mean that the apportionment factors of all the entities in which Mr. Winget is a shareholder are combined to produce an apportionment percentage to be applied to each item of income or loss from each corporation, in order to determine the non-Michigan portion that is to be either added to or subtracted from the tax base.

Under the Michigan Income Tax Act ("the Act") a member of a pass through entity combines business income from all sources to determine taxable income. Taxable income that is subject to Michigan income tax is "the same as taxable income as defined and applicable to the subject taxpayer in the internal revenue code, except as otherwise provided in this act." MCL 206.2 (3).

Petitioners argue that the Act neither requires nor prohibits the combination of factors for apportionment at the taxpayer/shareholder level. Petitioners' 2001 and 2002 MI-1040 combined the property, payroll and sales factor for each of the subchapter S corporations/pass-through entities to arrive at a combined factor. Petitioners' Post Hearing Brief, page 4.

Petitioners' accountants multiplied the combined non-Michigan apportionment percentage by the loss distribution of the subchapter S corporations to arrive at the non-Michigan loss, which is then added back to federal adjusted gross income. In similar fashion, the income distribution of each S corporation was multiplied by the non-Michigan percentage to arrive at the non-Michigan income, which was then subtracted from federal adjusted gross income.

Petitioners state that the subchapter S corporations involved in this case are not the "taxpayers" under the individual income tax act, but the Wingets are. Therefore, Petitioners claim that "apportionment of the subchapter S distributions at the shareholder/taxpayer level is appropriate unless barred by law." Petitioners argue that Michigan's income tax act and rules fail to address whether apportionment of business income be "made at the partnership level" or the "partner level."

Petitioners deny that Administrative Rules 206.12(16), (17), and (18) apply to this case because those rules address a situation where the taxpayer receives a distribution from a single entity and then is required to apportion it. "The rules do not address the apportionment methodology where a taxpayer is engaged in business activity within and without the state as a shareholder in either multiple S corporations or multiple partnerships." Petitioners' Reply Brief, page 3. Petitioners argue that the rules are ambiguous regarding the apportionment of multiple distributions to shareholders, and that this ambiguity must be resolved in favor of the taxpayers.

Petitioner states that Respondent's argument regarding MCL 206.105 is misguided, and that section merely sets forth the nexus requirement of the "taxpayer." Mr. Winget was taxable in another state and was required to apportion "all" business income. Petitioner also indicates that section 105 is silent regarding "apportionment at the shareholder level or entity level." Petitioners' Reply Brief, page 4.

**Respondent's Contentions**

Respondent argues that Mr. Winget, the sole shareholder of several S corporations, improperly combined the apportionment factors of the S corporations when calculating the apportioned distributive share of the income and losses of each corporation. "Petitioners reduced their

Michigan individual income tax liability by siphoning off Michigan income to other states through the improper application of payroll, property and sales factors that belonged to companies that did no business in Michigan." Respondent's Post Hearing Brief, page 3. While Petitioners argue that their chosen apportionment method is not prohibited, Respondent asserts that the combination of the apportionment factors is not supported by Michigan law.

Petitioners are subject to the Michigan individual income tax act (the "Act"). MCL 206.51(1). Petitioners are each a "person" subject to tax as a "resident individual" on their "taxable income." Several of the entities involved in this case have business activity that is confined solely to this state, and therefore, the income of those entities is <u>not</u> subject to apportionment. MCL 206.105. Rather, all of that income is allocated to Michigan.

Respondent's administrative rules were upheld by the Supreme Court in *Chocola v Department of Treasury*, 422 Mich 229; 369 NW2d 843 (1985). Rule 206.12(16) states that partnership distributive share income is "apportioned to Michigan by the partnership apportionment factors." Rule 206.12(17) requires that "All distributive income from a subchapter S corporation includable in the shareholder's adjusted gross income is subject to tax if allocated or apportioned to Michigan." Respondent notes that Rule 12(17) specifically refers to income from "a" subchapter S corporation and that the use of the singular tense ("a") conveys that the income shall be apportioned using the factors of that entity only. Rule 12(18) requires a corporation to apportion if the corporation is taxable both within and without Michigan. Respondent contends that Rule 12 as a whole directs income from each type of flow-through entity to be apportioned separately.

MCL 206.105 prohibits use of the apportionment factors of the “Michigan-only” entities, because that income is not subject to tax by another state and, therefore, the income is not subject to the apportionment provisions of the income tax act. No other state has jurisdiction to tax income earned by a Michigan resident from an S corporation whose business activity is confined to Michigan.

Respondent argues that the factors used to apportion the distributive shares are not the “taxpayer’s” (the Winget’s) factors because Petitioners, individually, do not have payroll or sales. Neither do they own any of the S corporation’s property in their individual capacity. Therefore, there is no basis for combining the factors “at the shareholder level.”

Respondent asserts that certain authorities cited by Petitioners do not support their claims. Attorney General Opinion 6122 and the *Port Huron & Detroit Railroad Company v Michigan Department of Treasury*, 106 Mich App 413 (1981).

**Conclusions of Law**

Petitioners are taxpayers subject to the Michigan individual income tax act (the “Act”). MCL 206.51(1). Petitioner Larry J. Winget is a “resident individual” under MCL 206.18(1)(a) who received distributive income as a shareholder of various subchapter S corporations. Under the Act, a taxable “person” includes a resident or nonresident individual or a “partner in a partnership as defined in the internal revenue code.” 206.51(9)(a)(i). The tax is imposed at the rate indicated under MCL 206.51 on “taxable income” defined by MCL 206.30. “Taxable income" is all "adjusted gross income as defined in the internal revenue code." MCL 206.30(1); MCL 206.28. Taxable income includes all income from any source whatsoever. Taxable income that is subject to Michigan income tax is "the same as taxable income as defined and applicable to the subject taxpayer in the internal revenue code, except as otherwise provided in this act." MCL 206.2(3).

For the years at issue, Petitioners' taxable income included "business income" derived from multistate business activity. That "business income" is subject to Michigan income tax to the extent it is apportioned to Michigan using a statutory three-factor formula. The issues in this case involve the application of the apportionment provisions found in Chapter 3 of the Michigan Income Tax Act, MCL 206.102, et seq.

Petitioners argue that the inclusion of income from the S corporations in the taxpayer's AGI implies that the apportionment factors of those entities must be combined "at the shareholder level." Petitioners cite section 2(3), which states that "it is the intention of this act" that Michigan taxable income "be the same as" federal taxable income under the IRC. This basic principle defines the tax base but does not control the provisions regarding "allocation and apportionment" of income earned from sources without this state. Business income from multistate activity is properly included in "taxable income," but some of that taxable income is apportioned outside Michigan – and hence not included in the apportioned or allocated tax base to which the tax rate is applied. MCL 206.2(3) does not support Petitioners' position.

Petitioners' adjusted gross income for the years at issue included the distributions from several subchapter S corporations, of which Mr. Winget is the sole shareholder, with the exception of "Harper Properties" of which he is a "60% or 70%" shareholder. The parties do not dispute that the income at issue is "business income" as defined by MCL 206.4(2):

> "Business income" means all income arising from transactions, activities, and sources in the regular course of the taxpayer's trade or business and includes the following …. MCL 206.4(2)

The definition of "business income" in the income tax act is substantially similar to and modeled after the definition of that term in the Multistate Tax Compact, which incorporates the Uniform Division of Income for Tax Purposes Act ("UDITPA"), MCL 205.581, Article IV (1)(a). "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business… MCL 205.581.

Because the business income at issue arose "in the regular course of the taxpayer's trade or business" within the meaning of MCL 206.4(2), it is concluded that Petitioner (Mr. Winget) is "the taxpayer" within the meaning of that section who effectively engaged in a "trade or business" by virtue of his status as a shareholder in the S corporations, some of which were engaged in multistate business activity.

The definition of "business income" in MCL 206.4(2) refers to the "taxpayer's trade or business." In this case, the distributions of business income arose from the distinct "trade or business" engaged in by each entity, which are not "taxpayers" under MCL 206.26. The apparent disconnect between the "taxpayer" and the "business activity" in some of the apportionment statutes arises from the fact that the apportionment provisions of the income tax act are "borrowed" from the UDITPA, which generally applies to corporate income taxes and other business activity type taxes that are imposed upon the business entity. UDITPA presumes that the "taxpayer" is the business entity that engages in business activity, and not an individual shareholder. Of course, under the individual income tax act, the shareholder is the taxpayer, but the shareholder does not directly conduct a "trade or business" in his or her individual capacity. However, as used in the various apportionment statutes relevant to this case, the "taxpayer's trade or business" is coterminous with the *entity's* "trade or business" for purposes of identifying "business income." If this were not true, then the income or losses at issue could not be characterized as "business income" and would not be subject to apportionment, in which case Petitioners would potentially be taxed on 100% of that income. Neither party takes this view.

The activities of the individual taxpayer (in his or her individual capacity) are irrelevant to the apportionment of the income. The statute must be interpreted to focus on the activities of the S corporation and not the activities of the resident individual taxpayer. If this were not so, then Mr. Winget (the shareholder) would have to demonstrate that he is individually taxable in a state other than Michigan (under MCL 206.103) in order to apportion his business income derived from multistate business activities of the S corporations. Following that logic, if Mr. Winget was not "taxable" in another state, this would potentially subject him to tax on 100% of his business income from any source whatsoever and he could not apportion his income according to MCL 206.103. A resident shareholder's income from "any source whatsoever" is subject to tax under the general rule found in MCL 106.110. *See ,Comm'n v Chickasaw Nation*, 515 US 450; 115 S Ct 2214; 132 L Ed 2d 400 (1995); *New York ex rel. Cohn v Graves*, 300 US 308; 57 S Ct 466; 81 L Ed 666 (1937). A state has sovereign power of taxation over all persons and property within its borders. *Brown v Maryland*, 25 US (12 Wheat.) 419, 448-49 (1827). A state has constitutional authority to tax all the personal income of its residents. *Cohn v Graves*, 300 US 308; 57 S Ct 466; 81 L Ed 666 (1937). However, Michigan law treats the distributive income from a multistate flow-through entity as apportionable business income, and follows the UDITPA approach, which is consistent with constitutional principles requiring fair apportionment. Therefore, the business income at issue arose from the "taxpayer's" trade or business within the meaning of MCL 206.4(2).

The starting point for the apportionment process is as follows:

> In the case of taxable income of a taxpayer whose income-producing activities are confined solely to this state, the entire taxable income of such taxpayer shall be allocated to this state, except as otherwise expressly provided in this act. MCL 206.102.

The initial inquiry is whether the "taxpayer" has income-producing activities that are "confined to this state." If so, the apportionment provisions do not apply, and the taxpayer's "entire taxable income" is "allocated to" Michigan. Consistent with the discussion above regarding "the taxpayer's trade or business," MCL 206.102 speaks to the "income-producing activities" of the entity. When determining the location of the business activity, the activity of the entity is relevant, as indicated by the situs of the entity's apportionment factors (payroll, property, and sales). It is not disputed in this case that the factors of the entity are used – the issue is whether the factors of different entities are combined when the income included in the taxable income of one common shareholder.

As used in section 102, “Taxable income of such taxpayer” refers to a specific distribution by the S corporation to Mr. Winget.

The Act distinguishes between apportionment (by formula) and “allocation,” which involves an assignment of income to a particular state. A taxpayer who lacks nexus with any other state *allocates* 100% of his or her taxable income to the state of Michigan, as provided by section 102 above. In such case, the apportionment provisions do not apply. As applied to Mr. Winget, it cannot be said that all of the various income-producing activities (the activities of the various S corporations) are confined to this state. Therefore, he is not required to “allocate the entire taxable income to this state.” However, it will be demonstrated in this opinion that under the facts of this case, the determination under section 102 must be made separately for each entity, and that some of the entities are not proven to be taxable in another state, in which case the apportionment provisions do not apply to such entities.[1]

Section 102 applies to “income-producing activities” of a particular entity. The “income-producing activities” of the S corporation *are* the taxpayer’s activities. It follows that the “taxable income” of a taxpayer must relate to the “income-producing activities” of that taxpayer. The statute refers to “the entire taxable income of such taxpayer,” which means the taxpayer’s

[1] This may be distinction without a difference in this case. Respondent determined that certain entities must apportion 100% of the tax base to Michigan because all payroll, property and sales are attributable to Michigan. This has the same effect as if the entire income from that entity were “allocated” to Michigan.

entire income from the “income-producing activities” that are confined to this state. “Income-producing activities” refers to *unitary* business activities. This section applies to the income and business activity of the 100% Michigan companies in this case, whose income-producing activities were confined to Michigan, as indicated on Exhibits R3 and R8. Section 102 plainly refers to a taxpayer whose activities are confined to this state, and there is no indication that “income-producing activities” of other entities should be considered when determining whether the income produced from “activity confined solely this state” should be subject to apportionment.

Section 103 provides as follows:

> Any taxpayer having income from business activity which is taxable both within and without this state, other than the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this act.
> MCL 206.103.

Section 103 sets forth the principle that a taxpayer with “multistate” business activity shall allocate or apportion the net income to the states in which the business activity occurs. This is accomplished either by formulary apportionment of business income or “allocation” of certain types of income. As used in section 103, allocation refers to assigning particular items of income to a state based on the character of that income. For example, rents from real property are allocated to the state where the real property is located, and the rents are not included with the apportionable business income. See MCL 206.111.

Section 103 is modeled after Article IV, Section 2 of the Multistate Tax Compact (also referred to as the “Uniform Division of Income for Tax Purposes Act” or “UDITPA”), which Michigan has enacted into law. MCL 205.581.

> Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this article. If a taxpayer has income from business activity as a public utility but derives the greater percentage of his income from activities subject to this article, the taxpayer may elect to allocate and apportion his entire net income as provided in this article. MCL 205.581, UDITPA, Article IV(2).

“Income from business activity” includes “business income” that is subject to formulary apportionment. The term “taxpayer” as it appears in the UDITPA applies generally to corporations and includes any “person acting as a business entity.” Article II, section (3). Under UDITPA, the “taxpayer” is the “business entity.” The language was not specifically drafted to apply to an individual taxpayer who is a shareholder of a business entity. When the legislature adopted the UDITPA language in the Michigan income tax act, there was no confusion that the individual income tax is not imposed upon a business entity, but on the personal income of individuals.[2] This must be kept in mind when interpreting the sections of the Michigan Individual Income Tax Act that were modeled after the UDITPA. Therefore, the phrase “taxpayer having income from business activity” as it appears in the UDITPA language contained in the Income Tax Act applies to the business activity of the entity. The UDITPA

[2] The Multistate Tax Compact, which incorporates UDITPA, was enacted in Michigan by 1969 PA 343, after the enactment of the “income tax act of 1967,” 1967 PA 281. However, the UDITPA was drafted in 1957 by the National Conference of Commissioners on Uniform State Laws, and served as a model for many state income tax acts.

language evinces a continuity of the "taxpayer" the "income" and the "business activity." The language presumes that the income is produced from a *unitary* business activity.[3]

When a Michigan resident individual earns personal income from multistate business activity, the apportionment of that income is subject to the same principles and limitations found in and underlying the UDITPA. A taxpayer that is "taxable" in another state is subject to apportionment. A taxpayer is "taxable" in another state if the taxpayer is either subject to a tax based on net income or a business privilege type tax, or if another state has jurisdiction to tax, whether or not it does so. MCL 206.105 and MCL 205.581. In order to be subject to tax in another state, a taxpayer must have nexus with the other state, and conduct "business activity" in that state.

In our case, Petitioners received distributions of income from the business activity of the S corporations, three of which were taxable both in Michigan and in another state in 2001. Twelve of the entities from which Petitioners derived income were not taxable by any state other than Michigan. The distributive share related to the Michigan companies is not subject to apportionment and must be allocated entirely to Michigan under MCL 206.102. Therefore, there is no basis for including the apportionment factors of the "Michigan" companies in a combined apportionment formula.

[3] The drafters of UDITPA provided the following commentary regarding the definition of business income: "This definition refers to 'the' taxpayer's trade or business as if he had one business. It is not intended by this language to require a taxpayer having several businesses to use the same allocation and apportionment methods for the businesses." See, Hellerstein, State and Local Taxation Cases and Materials (8th Ed) p 597.

Even if it were concluded that the income distributed from an entity with income-producing activity confined to Michigan must be apportioned, all of that income would be apportioned to Michigan using the factors of that entity. There is no basis in statute or rule for applying factors of other entities (representing different business activity) to that income arising from purely intrastate activity.

"Income from business activity" as used in section 103 refers to income arising from *unitary* business activity that is taxable both within and without this state. The statute calls for an inquiry of whether the business income arose from business activity that is taxable both within and without this state. If so, it is apportioned. Section 103 says nothing about how to apportion it (other than, the income is apportioned "as provided by this act"). However, the language refers to "income from business activity" which, like section 102 discussed above, means specific income that arises from specific business activity. (See the drafter's commentary cited in footnote 3, *supra*). The goal of formulary apportionment is to relate the business income to the business activity that produced it, by use of a formula consisting of factors that represent that business activity (the taxpayer's property, payroll, and sales). In order to determine whether the income is taxable outside this state, the location of the business activity that produced that income must be examined. The statute plainly focuses upon the location of the business activity of the entity that produced the income. This is determined by the factors of the entity. It defies the essential purposes of formulary apportionment to combine the factors of the entities in this case.

Petitioners advance a strained interpretation of section 103 under which a taxpayer who receives multiple distributive shares of income from different entities engaging in multiple business activities must apportion all of its income if any one of the shares of distributive income is "income from business activity which is taxable both within and without this state." Even if this were plausible, it is a further stretch to assert that the income must be apportioned using the *combined factors* of all the entities, even those that have no multistate activity. This approach would work to Petitioners' advantage in this case by pulling a large "loss" from a predominantly "non-Michigan" business into the tax base. The statute states that any taxpayer (Mr. Winget) who has income from multistate business activity shall apportion "his net income" as provided in the Act. At most, this means that Mr. Winget's net income is subject to the allocation and apportionment provisions of the Act. It does not follow that the distributive shares of each company must be apportioned using the combined factors of all the companies. The act does not provide for the outcome sought by Petitioners.

As discussed above, specific language from UDITPA was incorporated into the Michigan individual income tax act. The apportionment language applies to the "business income" derived from a *unitary* multistate business, which is a constitutional requirement.[4] A "multistate

[4] "The federal constitutional restraints bearing on state division-of-income issues have largely shaped the state statutory framework governing division of corporate income. The two principal constitutional restraints with special relevance to division of the corporate income tax base – the unitary business principle and the fair apportionment requirement … are reflected in most states' corporate income tax regimes." Hellerstein, State and Local Taxation Cases and Materials (8th Ed) p 597. Professor Hellerstein states that UDITPA incorporates these constitutional principles.

business" is one that has contacts with more than one state, conducts business in more than one state, and derives income from more than one state. Application of the three-factor formula produces a reasonably accurate measure of the income derived from activity in the taxing state. The "business activity" referred to in section 103 of the income tax act is "unitary" in nature such that the apportionment factors related to that activity are applied to the income produced by that activity, so as to fairly apportion the tax base among the various states in relation to where the business is conducted.

The United States Supreme Court has held that a state may only tax an apportioned share of the income of a multistate business if there is a rational relationship between the income attributed to the taxing state and the "interstate values of the enterprise." *Moorman Mfg Co v Bair*, 437 US 267; 98 S Ct 2340; 57 L Ed 2d 197 (1978). In is not enough for a state to establish that a taxpayer has nexus with the state in order to tax an apportioned share of that entity's multistate income under the Commerce Clause and Due Process Clause of the US Constitution, but there must also be a "rational relationship between the income attributed to the taxing state and the interstate values of the enterprise." In other words, the "fair apportionment" principle requires that the factors used in an apportionment formula must fairly relate to the entity's business activity in that state that produced the income. Respondent's method achieves this result.

Furthermore, a state may only tax an apportioned share of income of a multistate business if that income arises from a *unitary* business activity with nexus to that state. *Allied-Signal, Inc v*

*Director, Division of Taxation*, 504 US 768; 112 S Ct 2251; 119 L Ed 2d 533 (1992). The "unitary business principle" is a constitutional limitation upon a state's power to tax and has been called the "the linchpin of apportionability in the field of state income taxation." *Exxon Corp v Department of Revenue*, 447 US 207; 100 S Ct 2109; 65 L Ed 2d 66 (1980); *Mobil Oil Corp v Commissioner of Taxes*, 445 US 425, 439; 100 S Ct 1223; 63 L Ed 2d 510 (1980); and, *ASARCO, Inc v Idaho State Tax Commn*, 458 US 307; 102 S Ct 3103; 73 L Ed 2d 787 (1982). Therefore, no state may announce that it "does not follow" the unitary business principle. Michigan's income tax statutes must be interpreted in light of the constitutionally mandated unitary business principle. An interpretation that allows for a combination of apportionment factors of non-unitary businesses cannot stand and is contrary to Michigan's apportionment statutes.

In *Complete Auto Transit, Inc v Brady*, 430 US 274; 97 S Ct 1076, 51 L Ed 2d 326 (1977), the Supreme Court set forth a four-part test to define the constitutional limitations on a state's power to tax interstate commerce. The "nexus" and "fair apportionment" prongs of that test are especially relevant to this case. The court relied upon older cases holding that a state tax on interstate commerce is permissible when the tax is "applied to an activity with a substantial nexus with the taxing state" and the tax "is fairly apportioned." The court also cited prior authorities to clarify that a state may only apply a tax "to a fair proportion of the *taxpayer's business* done within the state…." [Emphasis added.] The Court cited with approval *Colonial Pipeline Co v Traigle*, 421 US 100; 95 S Ct 1538 (1975), which held that a state may impose "properly apportioned state corporate taxes upon foreign corporations doing an exclusively interstate business when the tax is related to a *corporation's local activities* and the State has provided benefits and protections for those activities for which it is justified in asking a fair and reasonable return." [Emphasis added.]

The Supreme Court made it clear that "fair apportionment" means that the method of apportionment must relate to the business activity conducted within the taxing state. Therefore, both the "nexus" prong and the "fair apportionment" prong focus on the nature and extent of the taxpayer's business activity within the taxing state and the income related to that activity. The tax may only be applied to an "activity" that has substantial nexus to the state. For nexus purposes, there must be a connection between the in-state contacts and the business activity that produces the income. The same holds true under the "fair apportionment" prong, which requires that the tax be apportioned using factors that relate to the in-state business activity. *This simply does not allow for apportioning the tax base using factors that represent the business activity of other, non-unitary businesses.* The tax must relate to the "taxpayers' business done with the state" and not the business of some other entity that has business activity unrelated to the taxpayer's business activity. It is impermissible to include income in the apportionable tax base unless the activity that produced that income has nexus with the taxing state and from this principle, it naturally follows that fair apportionment requires that the factors fairly represent the unitary business activity that created nexus.

The unitary business principle must be distinguished from "unitary combined reporting" which some states apply to an affiliated group of entities that constitute a unitary business. Under appropriate facts, a state may allow or require a related group of entities engaged in unitary multistate business to be treated as a single taxpayer for purposes of calculating the net income of the unitary business, and apportioning that income to the taxing state. This is referred to as "unitary combined reporting," which is not expressly recognized under the Michigan individual income tax act. Combining the factors of related entities would only be appropriate if using the factors of each separate entity failed to fairly represent the extent of the entity's business activity in this state. This would typically require a determination that the entities were "unitary." Although combing the factors could be utilized under the "alternative apportionment" provisions of UDITPA, Article IV, section 18 and MCL 206.195, Petitioners have not sought or demonstrated a right to alternative apportionment pursuant to section 195.

Petitioners' business income from multistate entities that are taxable both within and without this state is subject to apportionment, using an equally weighted, three-factor formula. MCL 211.115. The three factors are property, payroll, and sales. The property, for purposes of the property factor, is "…the average value of the *taxpayer's* real and tangible personal property owned or rented in this state…." MCL 206.116 [Emphasis added.] In similar fashion, the "payroll factor" consists of the "total amount paid…by the taxpayer for compensation…." MCL 206.118. Finally, the "sales factor" consists of "…total sales of the taxpayer…." MCL 206.121. The Act calls for the factors to consist of the "taxpayer's" property, payroll, and sales. For the formula to work as intended, the factors of the entity that produced the income must be applied to that income, not some other entity's income.

Under a forced reading of the above statute, the *taxpayer*, Mr. Winget, in his individual capacity, would have no property, payroll, or sales related to the S corporations. Neither party suggests such an interpretation but agree that the factors *attributable to the various S corporations* must be used in the apportionment formula, notwithstanding that the S corporations are not the "taxpayers" as defined under the act. The dispute is whether the income and loss of each entity must be apportioned using the factors of that entity (as Respondent contends) or whether the factors of all the entities must be combined and then applied to the individual distributive income and loss of each entity.

Ms. Caldwell testified that Mr. Winget, as the taxpayer, *indirectly* owns property of the entities, has payroll, and has sales, related to the various entities that he owns and controls. This theory is apparently offered as a means of transferring or shifting the factors from the entity to the "shareholder level" where they can be combined and applied to the net income and losses from each entity in order to calculate the tax base apportioned to Michigan. It simply does not follow that the factors must be combined, whether viewed at the entity level or at the shareholder level.

Framing the issue as whether the apportionment formula is considered to be applied "at the taxpayer/shareholder level" or at the "entity level," as suggested by Petitioners, obscures the real issue, which is whether the income and loss of each entity must be apportioned using the *combined factors* of all the entities.

Petitioners' accountants multiplied the combined non-Michigan apportionment percentage by the loss distribution of the subchapter S corporations to arrive at the non-Michigan loss, which was then added back to federal adjusted gross income. In similar fashion, the income distribution of each S corporation was multiplied by the combined non-Michigan percentage to arrive at the non-Michigan income, which was then subtracted from federal adjusted gross income.

An example of Petitioner's approach is as follows: Mr. Winget is the sole shareholder of Venture Leasing. The property, employees, and sales of Venture Leasing are located predominantly outside Michigan. (Respondent calculated a "non-Michigan apportionment %" of 99.3981 for 2002. Exhibit R 8). In 2002, Venture Leasing reported a business loss of $29,177,122. Because the starting point for the tax base is federal AGI, the taxpayer's business income (prior to apportionment) includes all income and loss (both the Michigan and non-Michigan portions of the loss). The parties agree that the "non-Michigan" loss must be determined and added back to AGI. For 2002, under Petitioners' approach, the sum of the payroll factor, property factor, and sales factor divided by three is .4189 (41.89%). Therefore, the non-Michigan factor equals .5811 (58.11%), which Petitioners calculated using the combined apportionment factors of all the entities. The loss attributable to Venture Leasing ($29,177,122) was multiplied by 58.11%, producing a non-Michigan loss of $16,954,825, which was added back to AGI. (All of the loss is included in the pre-apportioned tax base. The "non-Michigan" portion of the loss must be disallowed, or added back to the tax base.)

Respondent's approach shall also be illustrated by the treatment of Venture Leasing as set forth on Respondent's Exhibit 8. For 2002, Venture Leasing's property factor was 1.187%, meaning that only 1.187% of its total property (valued at $496,487,328) is located in the state of Michigan. Venture Leasing reported no Michigan payroll. Only .6185% (.006185) of its total sales are "Michigan sales" as defined by MCL 206.122 and or MCL 206.123. Using these figures, the "non-Michigan" apportionment as calculated by Respondent is 99.3981%. Using this approach, 99.3981% of total loss is added back to AGI ($29,001,519).

Respondent's approach produces a more rational result. Petitioners failed to demonstrate that their method is consistent with statute or that it more accurately reflects the Michigan business activity of Venture Leasing. The Tribunal finds no factual or legal basis for application of apportionment factors of the other entities to the distributive share from Venture Leasing. In the same way that Michigan is precluded from apportioning income from Venture Leasing using factors that bear no relationship to that income, there is no sound rationale for apportioning a loss from that entity to Michigan using those factors as claimed by Petitioners. There must be "a rational relationship between the income attributed to the taxing state and the interstate values of the enterprise." *Moorman Mfg Co v Bair*, 437 US 267, 272-273 (1978). Using Venture Leasing's factors to apportion the loss from its business activity achieves such a result under the facts of this case.

Petitioners' main theory offered to support combining the factors of all the entities is that there is nothing in the statute prohibiting a combination of the factors "at the shareholder level." The

Tribunal finds this unpersuasive. Petitioners cite *Molter v Dep't of Treasury*, 443 Mich 537; 505 NW2d 244 (1993), for the proposition that Respondent may not "recompute and assess a taxpayer based on an apportionment method that has not been set forth in statute." Respondent's method of apportionment is not an unlawful "extension by implication" of taxing authority as Petitioners contend. There is no question that Petitioners are Michigan resident taxpayers who received business income subject to tax. The Tribunal is convinced that Respondent's approach is a more straightforward and rational application of the apportionment statutes and rules, and that Petitioners' approach involves speculation and an implication of provisions that have no basis in the Act or rules.

As originally calculated by PWC, the income and losses from several entities with no connection to Michigan were not apportioned, although Petitioners changed this position at the hearing. Initially, all of the loss attributable to a non-Michigan entity was added back to AGI and all of the income attributable to a non-Michigan entity was subtracted from AGI. Petitioners' Exhibit P3 states that these entities are "Non unitary companies located in Ohio." These entities are identified on Exhibit R-3 and R-8. Therefore, it would appear that the person at PWC who prepared the return believed that only the factors of the companies engaged in a unitary business should be combined. Petitioners' witness testified that the income and losses of the non-Michigan entities should be apportioned using the same method as the other income and losses.

With regard to all of the entities at issue, other than generalized testimony that they were engaged in automotive related businesses, there are no facts to support a conclusion that the entities constitute a “unitary” business. This suggests that even under the theory pursuant to which the original return was filed (excluding income and losses of non-unitary businesses) the factors should be combined only for those entities that are together engaged in a unitary business. However, the facts do not support a conclusion that they were so engaged. In this case, Petitioners advocate a form of “combined reporting” by combining the factors. The Michigan Income Tax Act does not provide for the combined reporting of the income or apportionment factors of multiple entities, whether or not they are involved in a unitary business (other than section 195, which Petitioner has not asserted in this case). The Tribunal is not convinced that an apportionment percentage produced by combining the factors of the various entities fairly reflects the extent of the taxpayer’s business activity properly attributable to this state.

This opinion will now address several of the specific arguments raised by the parties.

Petitioners argue that, “…the subchapter S corporations are not subject to the Income Tax Act, while the taxpayers (Wingets) are clearly ‘taxpayers’ who are subject to Michigan income tax. Therefore, the apportionment of income of the subchapter S distributions must be considered at the shareholder/taxpayer level unless barred by statute.” Petitioners’ Trial Brief, p 6. Identifying the “taxpayer” as the Wingets does not require a combination of the apportionment factors. There is no dispute that the Wingets are the taxpayers. The S corporations are not subject to the Income Tax Act, but the Act clearly calls for the apportionment of business income received as a distributive share from the S corporations. The only reasonable interpretation of the Act is that the income distributed by an entity must be apportioned using the factors of that entity. Petitioners have not persuaded the Tribunal that the act requires or allows a combination of the factors of the various entities in this case. As explained in this opinion, the apportionment provisions of the Act are consistent with the Multistate Tax Compact (which includes the Uniform Division of Income for Tax Purposes Act, or "UDITPA"). Those provisions must be understood in the context of recognized constitutional limitations upon that state's power to tax. Petitioners erroneously contend that the income tax act allows income from non-unitary businesses to be apportioned using the combined factors of those businesses.

Petitioners cite *Port Huron & Detroit Railroad Company v Department of Treasury*, 106 Mich App 413 (1983). That case involved the interpretation of a transitional provision included in the newly enacted Single Business Tax Act, which applied only to the 1977, 1978, and 1979 tax years. The SBT took effect January 1, 1976. The provision at issue, MCL 208.57(3), created limitations upon the SBT liability, and included a minimum tax based on the preceding five-year average of certain business taxes (including state corporate income tax) formerly paid by that taxpayer. MCL 208.57(3) used the phrase "taxpayer's liability for the taxes" under the former income tax act. The meaning of that phrase was in dispute. The taxpayer was an S corporation, which, as a flow-through entity, paid no corporate income tax, but rather the business income was taxable to the individual shareholders. The S corporation was the "taxpayer" under the SBTA. MCL 208.10(2). There was no question in that case that the term "taxpayer" as used in MCL 208.57(3) did not refer to the individual shareholders of the S corporation. The individual's tax liability under the former income tax act could not be equated with the "taxpayer's [S corporation's] liability" under the income tax act. A literal application of the unambiguous statute demanded that the shareholders' prior income tax liability could not be treated as the corporation's tax liability. Therefore, the court ruled that the taxpayer in that case was the corporation, which had no liability under the former corporate income tax act. That ruling was sufficient to resolve the case.

The court proceeded to note that the Single Business Tax was imposed upon "the adjusted tax base of every person with business activity in this state which is allocated or apportioned to this state." MCL 208.31(1). The shareholders were not "persons with business activity" and therefore were not "taxpayers" under the SBTA. This is quite distinguishable from our present case where the individual shareholder of the S corporation is the taxpayer. The income tax is unquestionably imposed upon the taxpayer's [Mr. Winget's] "business income." The SBT was imposed at the entity level, including S corporations, partnerships, or other non-incorporated entities that are not subject to federal corporate income taxes. *Port Huron* stands for the proposition that an S Corporation shareholder is not a "taxpayer" with "business activity" under the <u>SBTA</u>. Treasury took the position that the *income tax* paid by the shareholders must be included in computing the tax liability of the S corporation under the SBTA. This was held to be contrary to the plain language of the SBTA, which called for consideration of income taxes paid in the last five years by the S corporation "taxpayer" – which liability was unquestionably zero due to the S corporation status. Petitioner cites *Port Huron*, a Single Business Tax case, to support a point of law that is not in dispute in this case. That is, "the identity of the taxpayer" is not disputed here. *Port Huron* does not support a ruling that the apportionment factors of the various entities must be combined merely because the Wingets are *the taxpayers*. The *Port Huron* case has no persuasive value to the interpretation of the apportionment provisions of the Michigan individual income tax act under the facts involved in this case.

The following 11 entities have a 100% apportionment percentage for 2002, meaning that all of the property, payroll, and sales, are located in Michigan: Vemco Inc., Vemco Leasing, Venture Mold, Venture Service, Venture Automotive, Venture Sales & Engineering, Venture Equipment Acquisition, Patent Holding, Venture Heavy Machinery, and Modas. There is no question that if each of these entities were owned by one Michigan resident shareholder with no other business income, the distributive shares would be allocated (100%) to Michigan under MCL 206.102. The income would not be subject to apportionment under MCL 205.103 and ensuing provisions (MCL 206.111 through MCL 206.115). As discussed above, the distributive income that Petitioner earned from the Michigan based companies is not subject to apportionment, and Respondent's apportionment method effectively recognizes this. (Exhibits R-3 and R-8 show apportionment of 100% .)

The factors of Venture Leasing, with a small fraction of its activity attributable to Michigan, cannot be combined with the 100% Michigan companies, to produce a fanciful apportionment percentage. This produces a distorted result under which the income of a company with all of its property, payroll, and sales in Michigan, apportions a significant portion of its income to sources outside Michigan by the force of factors of another entity that are not proven to bear any relationship to the Michigan business activity.

A taxpayer has a right to petition the department for an alternative apportionment method if the standard formula does not fairly represent the extent of a taxpayer's business activity in this state. MCL 206.195 and MCL 205.581. Petitioners did not petition for such administrative relief in this case. Even if Petitioners had requested alternative apportionment (e.g., combining the factors) under section 195 of the Act, the facts and law do not support granting it. There are no facts to prove that combining the factors fairly reflects the extent of the income that should be apportioned to this state. In a case where the taxpayer is a Michigan resident shareholder of an S corporation with all its payroll, property and sales in Michigan, and which lacks nexus with any other state, and which is not part of a unitary multistate business, there is no basis in Michigan tax law for apportioning that income using the factors of other entities, merely because they are owned by the same shareholder. Furthermore, there is no basis for apportioning a loss produced by a predominantly non-Michigan company to Michigan using the apportionment factors of non-unitary "Michigan" companies.

It must be emphasized that the discussion of the unitary business principal in this opinion does not imply that combination of the factors would be permitted or required even if Petitioners had plead and proved that some or all of the entities were engaged in a unitary business. It does not violate the unitary business principle to consider each entity separately for apportionment purposes. Petitioners have failed to prove that combining the factors would be consistent with the unitary business principle or the Michigan Income Tax Act.

Respondent states the treatment of the income at issue is governed by R 206.12. As a general proposition, Rule 12(3) states that "Income from a trade or business. . . is allocated or apportioned to the state in which the activity takes place." This rule does not allow business income to be apportioned to a state in which the activity *did not take place,* which is the likely result if factors of other entities are used to apportion that income.

Rule 206.12(16) applies to "distributive share items received by a partner" which are allocated or apportioned. Ordinary income distributed by a partnership is "apportioned to Michigan by the partnership apportionment factors." Although this rule applies to a partnership, it is instructive in our case, because the S corporations are flow-through entities that are taxed like partnerships.

Rule 12(17) states: "All distributive income from a subchapter S corporation includable in the shareholder's adjusted gross income is subject to tax if allocated or apportioned to Michigan."

Rule 12(20) states: "Distributive income from a subchapter S corporation not allocated or apportioned to Michigan may be claimed as a subtraction from adjusted gross income. Conversely, losses not allocated or apportioned to Michigan shall be added to adjusted gross income." This rule supports the apportionment method advanced by Respondent in this case. Quite simply, it calls for a determination of the "non-Michigan" item of income, which is subtracted from AGI, and the non-Michigan portion of a loss is added back to AGI. The determination of the non-Michigan portion is calculated on an entity-by-entity basis, which naturally is performed using the factors of each entity.

Respondent argues that Rule 12 "does not combine the activities of flow-through entities." Brief page 6. The Tribunal agrees that Rule 12(16) supports the view that distributive income from a flow-through entity is apportioned "by the partnership apportionment factors." There is no reason why the rule for an S corporation should be any different. In *Chocola*, our Supreme Court held that "Subchapter S corporations enjoy unique characteristics that provide a compelling analogy to partnerships, which produce apportionable business income in the hands of member partners. *Id* 243. Therefore, there is reason to believe that the principle stated in Rule 12(16) pertaining to partnerships applies to S corporations. The proposition that the income should be apportioned using the S corporation's factors is so unremarkable that it is not surprising that the drafters of Rule 12(17) and (20) [pertaining to S corporations] saw no need to state that the distributive income should *not* be apportioned using factors of *another* entity. The rule certainly provides no support for Petitioners' view.

Rule 12(17) applies specifically to S corporations. Respondent points out that it applies to "distributive income from *a* subchapter S corporation" which is subject to tax if allocated or apportioned to Michigan. [Emphasis added]. Respondent argues that the use of the singular ("a" subchapter S corporation) means that the corporation's income is apportioned using that corporation's factors. This rule states that business income will be apportioned, if it is derived from a multistate business activity, otherwise it will be allocated to Michigan. When read in context with Rule 12(16), there is no reason to believe that any factors other than the S corporation's factors should be used to apportion the income and loss of that S Corporation. The rule provides absolutely no support for Petitioners' position – which leaves Petitioners to argue that the rule does not expressly prohibit their approach. The Tribunal concludes that the various provisions of Rule 12 support the apportionment of distributive income from a flow-through entity using the factors of that entity.

*Chocola* upheld the validity of these rules. Rules 12(17) and 12(20) apply to distributive income from a subchapter S corporation. The Rule 12(17) states that the income included in AGI is subject to tax "if allocated or apportioned to Michigan." If it is "allocated to Michigan" then all of the income is subject to tax.[5] Therefore, Rule 12(17) contemplates that all of the income arising from a "Michigan" S corporation (not taxable in any other state) is "allocated" to Michigan and subject to tax. In addition, if the income is determined to be "non-business income" or business income of a certain character, it would be "allocated" either to Michigan or to another state under MCL 206.111 to 114, and not subject to formulary apportionment under MCL 206.115.

Petitioner cites Fenway, McLaughlin, Salmon, Smith, Tilly & Wood, *State Taxation of Pass-Through Entities and Their Owners*, Sec. 9.02 and 9.03. That work explains, in relevant part, that "apportionment at the partner level" and at the "partnership" level refers to the selection of factors, but does not provide specific support for Petitioners' position. Section 9.03 discusses an approach by which partners of a single partnership "combine their share of pass-through entity apportionment factors with their other apportionment factors." This does not expressly describe the fact pattern in this case. The combination of factors described in section 9.03 refers to combining a share of the partnership's factors (partnership property, payroll, and sales) with the factors of an individual partner, such as a corporate partner that conducts its own business activity. There is no indication that this discussion applies to combining factors of other S

[5] Under MCL 206.111, "net rents and royalties" from tangible personal property are generally "allocated" 100% to a particular state; however, under certain circumstances, rents and royalties are apportioned by a single factor formula consisting of number of days the property was located in this state / total number of days in the rental or royalty period. Rents and royalties are not subject to the three factor formula under MCL 206.111.

corporations of which the taxpayer is a shareholder. Furthermore, the assertion that another state follows such a method does not control Michigan law or administrative practice.

The discussion at section 9.03 also deals with combination of the factors of the partners, who in some states are required to "combine their share of pass-through entity apportionment factors with their other apportionment factors." In the example provided, if a corporation has a 60 percent interest in a partnership, the corporate partner would calculate its apportionment factor by including 60 percent of the partnership's sales, property, and payroll. There is no explanation of what is meant by the partner's "other apportionment facts." It is not clear from this text whether this refers to factors of other entities from which the taxpayer receives distributive income. There is certainly no indication that this statement contemplates the combination of factors of other entities at all.  There is no reason to believe that the cited text advocates combining factors of non-unitary businesses in the manner urged by Petitioners.

Petitioners argue that the act and rules are silent regarding the combination of factors, and that therefore, the act is "ambiguous" on this point, and that the ambiguity must be resolved in their favor under rules of statutory interpretation applicable to tax laws. Assuming *arguendo* that apportionment involves a statute imposing a tax, it must be noted that interpretations of apportionment provisions tend to defy the general rule that tax statutes must be strictly construed against the government. If the Tribunal were to interpret the Act and rules "in favor of" this taxpayer, it would necessarily work to the disadvantage of a different taxpayer (for example, a similarly situated taxpayer who receives significant distributive income from a predominantly "non-Michigan" company). Ruling in favor of Petitioners for the years at issue would also have a different effect upon this taxpayer in a year in which one of the S Corporations that has a loss in one year shows a profit in the next. The law requires a reasonable and revenue-blind interpretation in all cases, rather than an apportionment method that favors this taxpayer.

Petitioners cite *AZ Schmina v Dep't of Treasury*, 203 Mich App 187; 512 NW2d 157 (1993), which held that a taxpayer was entitled to calculate its gross receipts for Single Business Tax purposes using the same accounting method (the completed contract method) that it used for purposes of calculating federal taxable income. Federal taxable income is the starting point for calculating the SBT tax base. That case is distinguishable because Petitioners can point to no similar accounting method used for federal income tax purposes that allows it or requires it to combine the apportionment factors of the various entities. There is no calculation of state apportionment factors involved in calculating federal taxable income; whereas there is a calculation of "gross receipts or sales" on line 1 of the federal form 1120 (U.S. Corporate Income Tax Return).

Petitioners claim that under MCL 206.121, "total sales of the taxpayer" means all of the taxpayer's (Winget's) sales from all business activities, which requires combining the factors of the various entities. In its most straightforward application, this section simply instructs the taxpayer to include all of its sales "in this state" in the numerator, and all of its sales everywhere in the denominator of its sales factor. As discussed elsewhere in this opinion, the statute presumes that the "taxpayer" is engaged in a unitary, multistate business activity; and further, that the "taxpayer's sales" arise from the taxpayer's unitary business activity. Section 121 provides no guidance regarding the combination of apportionment factors of various flow-through entities. This language cannot be reasonably interpreted to support Petitioners' position.

Petitioners deny that Administrative Rules 206.12(16), (17), and (18) apply because these rules address a situation where the taxpayer receives a distribution from a single entity and is required to apportion it. "The rules do not address the apportionment methodology where a taxpayer is engaged in business activity within and without the state as a shareholder in either multiple S corporations or multiple partnerships." Petitioners' Reply Brief, page 3. Petitioners argue that the rules are "ambiguous" regarding the apportionment of multiple distributions to shareholders, and that this ambiguity must be resolved in favor of the taxpayers. Although the rules do not specifically address the exact fact pattern of this case, that does not make them ambiguous; and the silence on a particular point does not require the Tribunal to fill in the gaps with the approach advocated by Petitioners.

Upon careful consideration of the evidence and the law presented in this case, the Tribunal concludes that there the law does not support Petitioners' claim that the apportionment factors of the various S corporations must be combined when apportioning the distributive shares of the S corporation's income and losses. Respondent properly determined the apportionment factors for each entity consistent with the Income Tax Act and administrative rules.

**Judgment**

IT IS ORDERED that Final Assessments M393828 and M393829 are AFFIRMED.

IT IS FURTHER ORDERED that Petitioners' request for relief is DENIED.

IT IS FURTHER ORDERED that the parties shall have 20 days from date of entry of this Proposed Opinion and Judgment to file exceptions and written arguments with the Tribunal consistent with Section 81 of the Administrative Procedures Act (MCL 24.281). The exceptions and written arguments shall be limited to the stipulated facts. This Proposed Opinion and Judgment, together with any exceptions and written arguments, shall be considered by the Tribunal in arriving at a final decision in this matter pursuant to Section 26 of the Tax Tribunal Act [MCL 205.726; MSA 7.650(26)].

MICHIGAN TAX TRIBUNAL

Entered: December 15, 2009 Thomas A Halick