STATE OF MICHIGAN
DEPARTMENT OF LICENSING & REGULATORY AFFAIRS
MICHIGAN ADMINISTRATIVE HEARING SYSTEM
MICHIGAN TAX TRIBUNAL

R&L Carriers Shared Services, LLC,
Petitioner,

MTT Docket No. 413937

v

Michigan Department of Treasury,
Respondent.

Tribunal Judge Presiding
B. D. Copping

FINAL OPINION AND JUDGMENT

INTRODUCTION

Petitioner, R&L Carriers Shared Services, LLC, appeals a single business tax ("SBT") assessment issued by Respondent for the 2007 tax period and the denial of its SBT refund claim for the 2004, 2005, and 2006 tax periods.

The Tribunal finds Petitioner is entitled to a refund for the 2004, 2005, and 2006, tax years, based on its amended returns. The Tribunal further finds that Assessment No. R009948, relating to the 2007 tax year, should be cancelled.

BACKGROUND

Petitioner is an Ohio corporation that engaged in business activities within and outside of Michigan. Petitioner's business is to provide administration, operations, and support services to its affiliated companies, which are in the business of freight transportation, storage, logistics and real estate.

Petitioner filed amended SBT returns for 2004 through 2006, sourcing its sales of services pursuant to MCL 208.53. In the amended SBT returns, Petitioner claimed the following refunds:

Tax Period	Tax Type	Refund Claim
12/2004	SBT	$114,801
12/2005	SBT	$119,245
12/2006	SBT	$119,691

In addition, Petitioner filed its SBT return for the 2007 tax period utilizing the same method under MCL 208.53.

Respondent issued notices of adjustment for the tax years at issue on February 6 and February 13, 2009. Petitioner requested and Respondent granted an Informal Conference, which was held on August 30, 2010, with the Hearing Referee finding in Petitioner's favor. On March 9, 2011, Respondent issued a Decision and Order of Determination, finding against Petitioner and denying the refund claims. Respondent also determined that a deficiency existed in regard to the 2007 tax period. As a result, Respondent issued the following Assessment No. R009948:

Tax Period	Tax Type	Tax	Penalty	Interest*
12/2007	SBT	$10,057	$0	$

*Interest accruing and to be computed in accordance with MCL 205.23 and MCL 205.24.

Petitioner filed its appeal with the Michigan Tax Tribunal on April 12, 2011. Respondent filed its answer to Petitioner's appeal on May 6, 2011. Pursuant to the

Summary of Prehearing Conference and Scheduling Order, the parties each submitted a trial brief. A hearing was held on October 23, 2012, at which both parties presented the testimony of witnesses. Petitioner was represented by Charles Wright and Ryan C. Johnson, of Deloitte Tax, LLP. Respondent was represented by Michael R. Bell, Assistant Attorney General.

PETITIONER'S CONTENTIONS

Petitioner contends that it is entitled to a refund for overpayment of SBT under MCL 208.53(b) for 2004, 2005, and 2006, and cancellation of Respondent's assessment for additional taxes for 2007. To support its contentions, Petitioner asserts that (i) sales of services performed under a contract should be sourced to Michigan only if the majority of the costs of performing the services occurred in Michigan; (ii) Respondent's own Internal Policy Directive (IPD) 2006-8 supports Petitioner's position;

(iii) there is no legal basis for Respondent's theory that the services of each of Petitioner's individual employees represent a separate sale to each affiliate;

(iv) Petitioner's affiliates transact a minimal amount of activity within Michigan compared to other states; and (v) yearly and weekly cost of performance analyses prove that Michigan-related direct costs are far below 50%. (Petitioner's Trial Brief, pp 6 – 7).

In regard to the Uniform Division of Income for Tax Purposes Act (UDITPA), Petitioner states that the SBT shares many similarities with UDITPA provisions, and UDITPA clearly views a sale from the perspective of the entity receiving the income. Petitioner contends that although UDITPA does not directly apply to SBT, the result should be the same, as Petitioner does not receive income for the services of any individual employee, but instead receives weekly income from each affiliate for the totality of services provided to the affiliate during the week. (Petitioner's Trial Brief, pp 10 – 11). Further, Petitioner states that the Multi-State Tax Commission (MTC) issued a regulation in 2004 that has not been adopted by Michigan and Respondent has specifically rejected UDITPA regulations in IPD 2006-8. (Petitioner's Trial Brief, p 11).

Petitioner states that under the Administrative Services Agreement, it is paid to provide services throughout the country to its affiliates on a routine basis, with the payment equaling cost plus 5%. (Petitioner's Trial Brief, p 12). The issue between the parties is how a "sale" is defined for purposes of applying the cost of performance method. Petitioner contends that there appears to be two scenarios based on the case law and the parties' contentions (Petitioner's Trial Brief, p 13):

1. Pursuant to *Detroit Lions v Department of Treasury*, *Heartland Employment Services, LLC v Department of Treasury* and *Meristar Management Company, LLC v Department of Treasury*,

each enumerated service category in the Administrative Services Agreement represents a sale to each affiliate.

2. The services of Petitioner's individual employees each represent a separate sale to each affiliate. Under this approach, sourcing would follow the location of each individual employee performing services. As Respondent states in its IPD 2006-8, Policy Issue and Determination #4, there is no statutory basis for this opinion.

Petitioner provided an annual summary of costs of performance for the service categories in the Administrative Services Agreements in response to the discovery requests received from Respondent. The summaries related to R&L Carriers, Inc., which was the affiliate with the greatest presence in Michigan. "The percentage of costs incurred in Michigan over the total costs of performing the listed services does not reach 7% in any of the tax years." (Petitioner's Trial Brief, p 18; P-9). Petitioner also provided a sample weekly performance analysis, by service category, for the sample 2006 tax year, which resulted in a Michigan percentage averaging 3.5% overall. (Petitioner's Trial Brief, pp 18 – 19; P-8).

In regard to the applicable case law, Petitioner states that in *Detroit Lions, Inc v Dep't of Treasury*, 157 Mich App 207; 403 NW2d 812 (1986), 100% of the post season revenue was sourced to Michigan because the majority of the Lions' costs of being a part of the NFL occurred in Michigan. Petitioner contends that this transactional approach is stated in IPD 2006-8 and that the Tribunal decisions in *Heartland* and *Meristar* "build on the *Lions* reliance on a contract to establish a

'sale' transaction for purposes of applying MCL 208.53." (Petitioner's Trial Brief, pp 13 – 14). Petitioner states that *Heartland Employment Services, LLC v Dep't of Treasury*, MTT Docket Nos. 341804 and 359201 (March 18, 2009), specifically rejected Respondent's position of sourcing sales based on an employee's wages, and reaffirmed the concept that the scope of a sale is best defined by the contract between the parties. (Petitioner's Trial Brief, p 14). Contrary to Respondent's Decision and Order of Determination, Petitioner contends that *Meristar Management Company, LLC v Dep't of Treasury*, MTT Docket No. 320548 (August 31, 2010), does not support Respondent's case and does not contradict *Heartland*. Petitioner claims that *Meristar* supports a conclusion that a contract dictates the terms of a sale, as *Meristar* concluded that each individual management agreement was a distinct and separate sale. (Petitioner's Trial Brief, pp 15 – 16). Lastly, Petitioner states that *Honigman Miller Schwartz and Cohn LLP v Dep't of Treasury*, unpublished opinion per curiam of the Court of Appeals, issued July 30, 2009 (Docket No. 282768), is only persuasive and applicable when there is no formal contract and would have no application to the present case, where a formal contract existed between Petitioner and its affiliates.

PETITIONER'S ADMITTED EXHIBITS

P-1: Administrative Services Agreement dated December 30, 2003, and Amendment No. 1 dated July 29, 2004

P-2: Sample invoices for:

Jan. 2004 – April 2004
May 2005 – Aug. 2005
May 2006 – Aug. 2006
Sept. 2007 – Dec. 2007

P-3: Petitioner's response to Respondent's Second Discovery Request

P-4: Decision and Order of Determination regarding 2004 through 2006

P-5: Decision and Order of Determination related to 2007

P-6: Internal Policy Directive 2006-8, Sept. 29, 2006

P-7: Respondent's response to Petitioner's First Discovery Request

P-8: Weekly Costs of Performance Analysis for the 2006 tax year

P-9: Year End Costs of Performance Analysis for the 2004 through 2006 tax years

P-10: Petitioner's response to Respondent's First Discovery Request

PETITIONER'S WITNESS

Jeffrey Haungs

Mr. Haungs has been with R&L since June 1, 2005, and is the Vice President of tax for the R&L group of companies and is currently employed with Strategic Management, LLC. (Transcript, p 12). He did not prepare the original SBT returns, but did review them, and the sales apportionment was done by taking the "payroll as it was allocated, and push[ing] it to the sales figure." (Transcript, p 13). They later realized they did not apply the Michigan cost of performance rules and amended the 2004 through 2006 returns and filed the 2007 return using the cost of performance. (Transcript, p 13). Mr. Haungs testified that (i) all of Petitioner's affiliates do not do business in Michigan; R&L Transfer services the

Midwest, which includes Michigan; (ii) Petitioner and its affiliates have facilities in 44 states and operate in all 50 states; (iii) R&L Transfer services the three terminals in Michigan and services a total of maybe 20 states; and (iv) the majority of the services in Michigan are operational, "but there would be a little of every piece" that would be conducted in Michigan. (Transcript, pp 14 – 16). Mr. Haungs stated that Petitioner is compensated for providing services to its affiliates, which is billed based on the services used, including labor, taxes and benefits associated with the labor, the tools used, combined with a 5% markup (which is referenced as commission fees on the invoices). (Transcript, pp 16 – 18, p 49). The administrative fees on the invoices are for supplies and equipment. (Transcript, p 49). He further stated that the invoices for each affiliate are computed weekly by allocating the group of costs, based on a set percentage, and billing to all of the companies involved on a gross allocation. The invoices do not indentify an individual employee by name and do not identify services rendered in a specific state. (Transcript, pp 18 – 19). On cross-examination, Mr. Haungs stated that the allocation is based on a set percentage, which is based on what percentage of the country each affiliate operates in. The allocation has nothing to do with the number of employees or employee compensation. (Transcript, pp 45 – 47). He further stated that the majority of the staff is located in Ohio, but each

terminal has a manager and operations staff that are employees of Petitioner. (Transcript, pp 36 – 43).

RESPONDENT'S CONTENTIONS

Respondent contends that Petitioner is liable for a deficiency in SBT paid for 2007 and is not entitled to a refund for 2004, 2005, and 2006. To support its contentions, Respondent argues that (i) Petitioner erroneously sourced sales out of state; (ii) Petitioner incorrectly defined sales by service revenue streams, reflecting a 0% sales factor in its amended SBT returns and original 2007 SBT return; (iii) the cost of performance must be analyzed for each separately identifiable service or business activity that Petitioner provided to its affiliates; (iv) Respondent may look beyond the contract to identify sales for apportionment purposes, since the cost of performance test under MCL 208.53(b) must be applied to each sale and a contract may not necessarily constitute a single sale. (Respondent's Trial Brief, pp 3 – 4).

Respondent argues that IPD 2006-8 is consistent with the plain meaning of MCL 208.53 and is supported by the definition of business activity in MCL 208.3(2) and the definition of sales in MCL 208.7(1) and is consistent with what is required under the SBTA regarding the sale of tangible personal property. (Respondent's Trial Brief, p 7). Respondent further argues that MCL 208.53 is the counterpart to MCL 208.52, which governs the sourcing of sales of tangible personal property and states that "[s]ales of tangible personal property are in this

state [if] . . . the property is shipped or delivered to any purchaser within this state . . . ." Respondent contends that both statutes share a common purpose and must be read together as one law. (Respondent's Trial Brief, p 10).

With respect to the relevant case law, Respondent contends that *Detroit Lions* has no real applicability to the present case, as Petitioner is not trying to source its Administrative Services Agreement as a single sale. There is no meaningful distinction between the arrangements in Petitioner's Client Service Agreement and the service-as-needed arrangement in *Honigman*; Petitioner's Administrative Services Agreements described the types of services as the need arose but the "sale" was not generated until the service was provided and the business activity performed, which is evidenced by the monthly invoice and billing arrangement. *Heartland* is not relevant because Petitioner admitted that its Administrative Services Agreement does not constitute a single sale in its response to Respondent's discovery requests, and is also factually distinguishable because Petitioner has identified and provided invoices that document services performed by Michigan employees beyond the streams of revenue in the Administrative Services Agreement. Respondent further argues that *Meristar* involved sub-agreements that are analogous to the present case, where Petitioner's service recipients communicated their human resource needs in Michigan to Petitioner which represented individual sales. Lastly, Respondent contends that *USA*

Financial v Dep't of Treasury, MTT Docket No. 341985 (March 17, 2010), is factually and legally distinct, but does contain an analysis by the Tribunal regarding cost of performance case law. (Respondent's Trial Brief, p 12 – 15).

In regard to UDITPA and the MTC, Respondent contends that these regulations are not applicable to the SBTA or this case because (i) the MTC and UDITPA address apportionment for income tax purposes, not SBT purposes; (ii) any differences that may exist between the MTC, UDITPA and the SBTA have no bearing on this case; (iii) the Court of Appeals has declined to look to the MTC or other statutes because the SBTA is unambiguous. (Respondent's Trial Brief, pp 16 – 17). In support of its contention that the SBTA is unambiguous, Respondent cites to *Lason Systems, Inc v Dep't of Treasury*, unpublished opinion per curiam of the Court of Appeals, issued January 26, 2012 (Docket No. 300267), which held that the applicable provisions of the SBTA were not ambiguous and the Court would not look to other statutes in interpreting these provisions.

RESPONDENT'S ADMITTED EXHIBITS

R-1: Petition
R-2: Answer
R-3: Petitioner's 2004 Michigan SBT Annual Return
R-4: Petitioner's Amended 2004 Michigan SBT Annual Return
R-5: Petitioner's 2005 Michigan SBT Annual Return
R-6: Petitioner's Amended 2005 Michigan SBT Annual Return
R-7: Petitioner's 2006 Michigan SBT Annual Return

R-8: Petitioner's Amended 2006 Michigan SBT Annual Return

R-9: Petitioner's 2007 Michigan SBT Annual Return

R-10: SBT Annual Return Notice of Adjustment for tax year ending December 2004

R-11: SBT Annual Return Notice of Adjustment for tax year ending December 2005

R-12: SBT Annual Return Notice of Adjustment for tax year ending December 2006

R-13: SBT Annual Return Notice of Adjustment for tax year ending December 2007

R-14: Final Assessment R009948

R-15: Correspondence from Petitioner to Treasury dated November 9, 2007 regarding accompanying amended SBT returns for tax years 2004 – 2006

R-16: Correspondence from Petitioner's representative to Treasury dated March 27, 2009

R-17: Correspondence from Petitioner to Treasury dated March 25, 2007

R-18: Correspondence from Petitioner's representative to Treasury referee dated August 27, 2010

R-19: Petitioner's response to Respondent's First Discovery Request

R-19a: List of Terminals and Terminal Managers

R-19b: Invoices submitted by Petitioner to each "Service Recipient" or "Affiliate" for 2004, 2005, 2006, and 2007

R-19c: Supporting documentation for each respective invoice and wage detail

R-19c-1: Sample invoice detail

R-19c-2: Internal payroll data

R-19c-3: Weekly wage detail

R-19d: List of employees performing services in Michigan for 2004, 2005, 2006, and 2007

R-19e: Petitioner's amended return explanation

R-19f: Petitioner's weekly cost of performance analysis for 2006

R-20: Respondent's answers to Petitioner's First Request for Discovery

R-20a: Audit Report of Findings

R-21: Petitioner's response to Respondent's Second Discovery Request

R-21a: Exhibit 1 to Petitioner's response

R-21b: Exhibit 2 to Petitioner's response

R-21c: Exhibit 3 to Petitioner's response

R-21d: Exhibit 4 to Petitioner's response

R-21e: Exhibit 5 to Petitioner's response

R-22: Internal Policy Directive 2006-8

R-23: Spreadsheet reconciling Petitioner's sales as originally reported with Petitioner's responses to Respondent's second discovery request

RESPONDENT'S WITNESSES

Lance Wilkinson

Mr. Wilkinson is the Administrator of the Tax Policy Division and a licensed attorney. He testified that IPD 2006-8 has the purpose of explaining how to apply the cost of performance rules to the apportionment of services, which is done on a transaction-by-transaction basis. Another purpose of the IPD is to discuss that when evaluating costs, you limit yourself to the direct costs and not indirect costs, like general overhead. (Transcript, pp 57 – 59). Mr. Wilkinson stated on cross-examination that it is his belief that the "course of conduct under the Administrative Services Agreement indicated that service recipients in this case were purchasing particular services. And since the cost of those services could be identified, they were separate sales that should be sourced separately." (Transcript, p 64).

Brian Knotts

Mr. Knotts is a senior auditor with the Tax Compliance Bureau and reviewed the audit prepared in this case. The audit period was 1-1-2004 to 12-31-2005, and did not establish any SBT liability, and Petitioner did not contest any portion of the audit. (Transcript, pp 67 – 68). Petitioner filed amended returns after the audit was concluded, and Mr. Knotts reviewed the amended returns to verify the claim for a refund, which was based on cost of performance for the sales apportionment. (Transcript, p 69). Mr. Knotts stated that he prepared the schedule of what Respondent's position was, utilizing source documents provided by Petitioner, which included (i) Petitioner's ledgers; (ii) gross receipts by state; (iii) gross revenue by location; (iv) gross revenue by state; (v) gross revenue by city; (vi) 940 payroll; (vii) annual payroll; (viii) UIA 1020; and (ix) payroll from the original SBT annual returns. (Transcript, pp 73 – 79). From this documentation, Mr. Knotts testified that he was able to break out the costs by location, by adding up the wages reported on the original SBT return, and determining the wage percentage for each location. He further explained that on Exhibit 23, Column D multiplied by Column E equals the gross revenue as reported on the Michigan apportionment. He then looked at the general ledger and took the income accounts as the revenue, to show the direct costs incurred, which is listed in the aggregate. Mr. Knotts determined that Petitioner did not take into

account the discounts and then compared the Michigan UIA 1020 amounts, which shows the actual payroll claim for Michigan. Next, the total revenue allocated to Michigan based on the original SBT return, minus the 5% markup gave the direct costs. The Michigan direct costs for 2004 was the cost of wages plus the SUTA tax, totaling $11,357,323.84 divided by the total direct costs of $14,357,586, gave a percentage of direct costs allocated to Michigan for 2004 of 79.1%. The same method was done for 2005 and 2006. (Transcript, pp 77 – 84).

FINDINGS OF FACTS

On July 30, 2012, the parties filed a Joint Stipulation of Uncontroverted Facts, as follows:

1. Petitioner is R&L Carriers Shared Services, LLC, and is headquartered in Ohio.
2. Petitioner is in the business of providing administration, operations, and support services to its affiliated companies.
3. Petitioner's affiliated companies include the following:
    a. R&L Carriers, Inc. an Ohio Corporation;
    b. R&L Transfer, Inc. an Ohio Corporation;
    c. Gator Freightways, Inc., a Florida Corporation;
    d. Greenwood Motor Lines, Inc., a South Carolina Corporation;
    e. Paramount Transportation Services, Inc., an Ohio Corporation;
    f. R.L.R. Investments, LLC, an Ohio Limited Liability Company.
4. Petitioner's affiliated companies are in the business of freight transportation, storage, logistics, and real estate.

5. On December 30, 2003, Petitioner entered into an Administrative Services Agreement with R&L Carriers, Inc., Paramount Transportation Services, Inc., and R.L.R. Investments, LLC.

In addition to the parties' stipulated facts, the Tribunal finds the following facts:

6. Petitioner has three terminals in Michigan served by R&L Transfer, Inc., which services the Midwest region. There are a total of 94 terminals nationwide. (R-19a).

7. Petitioner originally filed returns for 2004, 2005, and 2006, and did not source its sales of services in accordance with MCL 208.53, but instead used payroll as it was allocated, and pushed that to the sales figure.

8. Respondent conducted an audit covering the tax period of 1-1-2004 to 12-31-2005. Petitioner did not contest the audit and the audit did not determine that any SBT deficiency existed.

9. Petitioner asserts that it is entitled to a refund for the 2004, 2005, and 2006 tax periods based on its amended returns, which reflect the sourcing of sales of other than tangible personal property based on the cost of performance method under MCL 208.53(b).

10. Petitioner filed its original 2007 SBT return in accordance with the methodology used for the amended 2004 through 2006 returns.

11. Respondent denied Petitioner's refund requests and issued an Assessment for additional taxes in the amount of $10,057 (plus statutory interest) for 2007.

12. The referee's Informal Conference Recommendation found in favor of Petitioner, cancelling the assessment for 2007 because "the petitioner's costs of performance were greater outside of Michigan, it properly sourced all revenue from its services outside Michigan."

13. The Informal Conference Recommendation relative to the amended returns for 2004, 2005, and 2006 found that the refunds should be granted, as "a majority of the petitioner's costs of performance for its services occurred

outside Michigan. Specifically, the petitioner is located in Ohio wherein its costs of performance for its services are greater than the costs of performance for its services in Michigan."

14. The Decision and Order of Determination reversed the referee's Informal Conference Recommendation relative to the refund claims for 2004 through 2006 and the assessment for 2007 and held that the refunds should be denied, and that the assessment should be upheld stating that "[t]he Referee erred in this case by apparently concluding that Petitioner treated the Administrative Services Agreement as a single sale" and that the legal conclusions reached by the Referee were "based on facts not presented on the record."

CONCLUSIONS OF LAW

MCL 208.41 provides that a taxpayer, whose business activities are taxable both within and without this state, shall apportion his tax base as provided in Chapter 3 of the Single Business Tax Act ("SBTA").

"'The single business tax is a form of value added tax . . . [or] a tax upon business activity.'" *Midwest Bus Corp v Dep't of Treasury*, 288 Mich App 334, 338-339; 793 NW2d 246 (2010), quoting *Trinova Corp v Dep't of Treasury*, 433 Mich 141, 149; 445 NW2d 428 (1989). The tax is calculated by first determining a taxpayer's tax base, which is the taxpayer's contribution to the economy, also described as "business income, before apportionment." MCL 208.9(1); *Midwest Bus Corp*, 288 Mich App at 338. When the taxpayer's business activities occur in multiple states, "only a certain part of its tax base is allocated to Michigan because a state may not tax value earned outside of its borders." *Id.*; see also MCL 208.41.

A tax base is apportioned between two or more states by considering three factors: sales, payroll, and property. *Midwest Bus Corp*, 288 Mich App at 338; see also MCL 208.45; M 208.45a. In *Ammex, Inc v Dep't of Treasury*, 273 Mich App 623, 655-656; 732 NW2d 116 (2007), the Court of Appeals held that the performance of services are sourced to Michigan under MCL 208.53(b) "if the greater proportion of the business activity is performed *inside* Michigan . . . ." (Emphasis in original.) It further held that "if a greater proportion of the business activity is performed outside this state," the activity does not qualify as Michigan sales under MCL 208.53(b). *Id.* at 656.

Petitioner is required to separately apportion its income from sales of tangible personal property under MCL 208.52 and sales other than tangible personal property under MCL 208.53. MCL 208.53 provides:

> Sales, other than sales of tangible personal property, are in this state if:
>
> (b) The business activity is performed both in and outside this state and, based on costs of performance, a greater proportion of the business activity is performed in this state than is performed outside this state.

Business activity is defined in MCL 208.3. MCL 208.3(2) provides, in part:

> "Business activity" means a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, within this state, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the

> taxpayer or to others, but shall not include the services rendered by an employee to his employer, services as a director of a corporation, or a casual transaction.

Under MCL 208.7(1)(a), "Sale" or "sales" means the amounts received by the taxpayer as consideration from the following:

> *(i)* The transfer of title to, or possession of, property that is stock in trade or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.
>
> *(ii)* The performance of services, which constitute business activities other than those included in subparagraph (*i*), or from any combination of business activities described in this subparagraph and subparagraph (*i*).

"Cost of performance" is not defined in the SBTA. Respondent's IPD 2006-8 provides guidance regarding costs of performance for SBT sales apportionment. IPD 2006-8 states, "[i]f the service is performed both within and outside of Michigan, then a taxpayer must demonstrate, using a 'costs of performance' analysis on a transactional basis, where the greater proportion of the business activity is performed." IPD 2006-8 defines "cost of performance" as

> direct costs that are determined in a manner consistent with a taxpayer's method of accounting for federal income tax purposes. Direct costs may include activities that are performed on behalf of a taxpayer to provided the contracted service, such as those conducted on behalf of a taxpayer by an independent contractor.

In the present case, the parties disagree on how a "sale" is defined and how the sourcing of sales should be calculated. Petitioner's argument is that the cost of

performance should be measured by each individual "revenue stream," as represented by the service categories in the Administrative Services Agreement. Petitioner provided an annual summary of costs of performance for the service categories in the Administrative Services Agreements and a sample weekly cost of performance analysis for the 2006 tax year. The percentages calculated by Petitioner in the annual summary were 4.27% for 2004, 4.14% for 2005, and 3.89% for 2006. The 2006 cost of performance analysis resulted in approximately 3.5% weekly.

Respondent's argument is that the cost of performance should be "analyzed for each separately identifiable service or business activity provided by Petitioner to its affiliates" with the "[c]ost plus price of services indicat[ing] that at least a portion of the sales at issue involve the sale of employee[s] [services], some of whom are located in Michigan." (Respondent's Trial Brief, pp 3 – 4). Respondent provided an analysis based on the percentage of Michigan wages compared to total wages, which was then applied to the gross revenue to arrive at a Michigan revenue allocation. The 5% markup was then removed from the Michigan revenue allocation to arrive at a total direct cost. Respondent then divided the Michigan wages by the Michigan direct cost calculated. This resulted in direct costs of 79.10% for 2004, 80.16% for 2005, and 82.15% for 2006.

The following is an analysis of the applicable case law cited by both parties:

Detroit Lions, Inc. (1987)

In this case the taxpayer was a member of the NFL, and based on its contract with the NFL, it received revenues from post season games. This revenue was received even though the taxpayer did not play in those games. The Court of Appeals found that membership in the NFL resulted in the taxpayer's right to the income. This resulted in sourcing 100% of the post season revenue to Michigan, as the majority of the taxpayer's costs of NFL membership occurred in Michigan.

Honigman Miller Schwartz and Cohn (2009)

In this case the taxpayer was a law firm located in Michigan that provided services to clients in Michigan and in other states. The taxpayer's attorneys kept detailed reports on where the services were performed and amounts billed, but had no formal contract for these services with its clients. For SBT purposes, the taxpayer included sales arising from services performed by an attorney while physically located outside Michigan in the sales factor denominator. The taxpayer included sales arising from services performed within Michigan in the sales factor numerator and denominator. The Court of Appeals held that each individual billing must be considered separately for apportionment purposes. Each service billed by the lawyer was a "business activity" within the meaning of MCL 208.53 and the location of that activity, either in Michigan, or outside Michigan,

determined whether the "business activity" was performed in this state, or performed both within and outside this state.

Heartland Employment Services (MTT 2009)

In this case, the taxpayer was providing human resource and employment services to other entities. Pursuant to the service agreements, Petitioner was responsible for all of the costs of the management and administration of the employees, including salary and benefits. Respondent modified Petitioner's original assessment after it recalculated Petitioner's sales factor so that Petitioner's receipts under its contracts were apportioned to Michigan based on payroll paid to service providers in Michigan to payroll paid to service providers everywhere. The Tribunal held that the taxpayer's employee leasing agreement showed that the "receipts must be sourced to the particular contract, rather than to a particular employee's wages, because services are provided to Petitioner's clients on a per-contract basis."

Meristar Management Company LLC (MTT 2009)

In this case, the taxpayer provided management services to various hotels and resorts. The taxpayer had both bulk management service agreements with multiple hotels and individual contracts with each hotel, outlining additional details regarding compensation for services. The Tribunal found that the separate

contracts set up distinct spending accounts and outlined distinct compensation, such that "each individual management agreement was separate, distinct, and should be independently examined to determine the location of the business activity for purposes of the cost of performance analysis of the management services." The Tribunal rejected the taxpayer's argument that the bulk management service agreement was one distinct sale and income stream.

Given the above analysis of the applicable case law, the Tribunal finds that *Detroit Lions* is not factually similar to the present case; however, Petitioner believes that this case supports its position that apportionment is based on a contract with a taxpayer's clients. The Tribunal agrees that the holding in *Detroit Lions* was based on the fact that the Lions contract with the NFL resulted in the Lions right to receive revenue from post season games. IPD 2006-8 also supports the use of a transactional approach when the business activity involves the performance of a service. Petitioner is not, however, attempting to source the Administrative Services Agreement as a single sale. Rather, Petitioner's method of sourcing in the amended returns and in the 2007 return was based on the separate "revenue streams" enumerated in each service category of the Agreement. The Tribunal finds that under the holding in *Detroit Lions* and IPD 2006-8, a transactional approach should be utilized when a contract exists. This is further supported by the case law referenced above. Only in *Honigman,* where a contract

did not exist, has the Court looked to individual billings to apply a cost of performance analysis. The present case is most similar to *Heartland*, where the Tribunal found that receipts should be sourced to the particular contract and not to the wages of the individual employees.

The Tribunal further finds that even if Respondent's contention was correct, the methodology it employed to calculate the percentage attributable to Michigan was flawed. If it were the appropriate method to use (which it is not because more than just employees' wages are included as a part of the calculation), the calculation would be based on the cost of the Michigan services (i.e., wages) divided by the cost of the services everywhere (i.e., total wages everywhere) or for 2004 $11,329,337.44 divided by $299,421,563, which equals 3.78%. This percentage is consistent with the fact that Michigan has only three terminals out of a total of 94 [3/94=3.19%].

While the Tribunal finds that the cost of performance analysis in this case should be applied in relation to the provisions of the Administrative Services Agreement, it must further be determined whether Petitioner's method of sourcing the sales under the contract was correct. Respondent contends that Petitioner's invoices document services performed by Michigan employees beyond the streams of revenue in the Administrative Services Agreement. Respondent has not elaborated on this contention, or specifically stated what services are contained in

the invoices that cannot be traced back to the Agreement. A review of the invoices submitted as exhibits by both parties reflects charges for Payroll Services, Taxes & Benefits, Admin Fees, and Commission Fees. Petitioner's witnesses testified that Admin Fees relate to supplies and equipment and Commission Fees relate to the 5% markup. All of the items referenced in the invoices relate to categories of services and fees stated in the Administrative Services Agreement. Further, Petitioner provided both an annual summary for each year and a detailed weekly summary for the 2006 year that reflects Michigan costs significantly below 50%. Under MCL 208.53(b) a greater proportion of the business activity was not performed in Michigan. As such, Petitioner correctly amended its 2004 – 2006 returns and filed its 2007 return to reflect the correct application of cost of performance. Petitioner is entitled to the refund amounts claimed in the amended returns filed for 204, 2005, and 2006. Further, Petitioner is not liable for the additional tax and interest for the 2007 tax year in Assessment No. R009948.

JUDGMENT

IT IS ORDERED that Petitioner's refund claims are GRANTED with respect to the amended SBT returns submitted by Petitioner for the 2004, 2005, and 2006 tax years.

IT IS FURTHER ORDERED that Assessment No. R009948, relating to the 2007 tax year, is CANCELLED.

IT IS FURTHER ORDERED that Respondent shall issue a refund within 28 days of entry of this Final Opinion and Judgment.

MICHIGAN TAX TRIBUNAL

By: B.D. Copping

Entered: December 26, 2012
klm