

SBT: ELIMINATE THROWBACK RULE

**House Bill 4910 with committee
amendments
First Analysis (10-21-97)**

**Sponsor: Rep. Kirk A. Profit
Committee: Tax Policy**

THE APPARENT PROBLEM:

Under Michigan's unique single business tax, companies that do business in many states, whether headquartered in Michigan or elsewhere, arrive at their "apportioned tax base" by using a three-factor formula based on the proportion of Michigan payroll to total payroll, Michigan property to total property, and Michigan sales to total sales. The three factors were once weighted equally, but changes in the act have put the emphasis increasingly on the sales factor. Legislation enacted in 1995 established a formula that for the 1997 and 1998 tax years weighs property 10 percent, payroll 10 percent, and sales 80 percent, and for the tax years after that weighs property 5 percent, payroll 5 percent, and sales 90 percent. The SBT act points out that "the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax year, and the denominator of which is the total sales of the taxpayer everywhere during the tax year."

favor of a company protesting the attribution of out-of-state sales to

One of the elements in determining which sales are to be counted as sales in Michigan (as part of the numerator) is the so-called throwback rule. The SBT act says that a sale into a state in which the taxpayer (the company) is not taxable is considered to be a sale in Michigan. Under the SBT, a company is considered to be taxable in another state, not only if it is actually subject to a tax, but also if "the state has jurisdiction to subject the taxpayer to [a tax] regardless of whether, in fact, the state does or does not." At issue is what tax specialists refer to as "nexus", which refers to the level of a company's physical presence in a state necessary for that state to be able to tax the company given the restrictions of the Commerce Clause of the United States Constitution. This is a complex and changing concept. Since it is favorable from an SBT tax standpoint to have sales attributed to other states rather than Michigan, there have been conflicts between Michigan companies and the Department of Treasury over which out-of-state sales should be "thrown back" to Michigan for tax purposes.

In a recent case (February 1997), Magnetek Controls v Revenue Division, Department of Treasury, the Michigan Court of Appeals ruled against the state and in

Michigan for SBT purposes. The court upheld a Court of Claims ruling that two weeks a year of "solid effort" in other states by company employees, along with the activity of independent sales representatives resident in those other states, was sufficient to meet the "substantial nexus" requirement of the U.S. Supreme Court. The company's presence in the other states was sufficient for the company to be considered taxable in the other states (whether they were actually taxed or not) and so the sales in those states could not be "thrown back" to Michigan. Subsequently, a Michigan Tax Tribunal decision (May 1997), Michigan Sugar Company v Michigan Department of Treasury, said that nexus existed in a number of states (but not in a few others) for a Michigan company where its sales employees or independent sales representatives made physical site visits and/or where the company had an independent sales representative resident and/or office. (The tribunal appears to have taken into account the dollar volume of sales in determining whether the company's presence was substantial or slight.)

Business groups argue that the Department of Treasury has been using an out-of-date standard of nexus in enforcing the throwback rule against Michigan companies (and in failing to pursue taxable activities in Michigan by out-of-state companies). They say that the throwback rule has been all but eliminated by recent court decisions and advocate its outright appeal to prevent more conflict and litigation.

THE CONTENT OF THE BILL:

The bill would amend the Single Business Tax Act essentially to eliminate the throwback rule as of January 1, 1998. Specifically, the SBT now says that a sale is considered to be a sale in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser. The bill would make that provision apply for tax years beginning before January 1, 1998.

MCL 208.52

FISCAL IMPLICATIONS:

The House Fiscal Agency reports that the fiscal effect of the bill in fiscal year 1997-98 would be a revenue reduction of approximately \$40 million. (Fiscal Note dated 6-16-97)

ARGUMENTS:

For:

By eliminating the throwback rule in the SBT, the bill will recognize the realities of recent court decisions on this issue and prevent further conflict and confrontation between Michigan companies and the Department of Treasury. Business representatives say that the estimates of revenue loss from this bill are not based on hard data and are exaggerated because recent court cases have reduced the ability of the department to apply the rule and the treasury department has plans to revise the throwback rule whether the bill is enacted or not. Besides, if the throwback rule stays in place, companies now can change their business practices to comply with court nexus standards and avoid tax. Further, adoption of a new nexus standard, coupled with aggressive enforcement, will bring in additional revenue from out-of-state companies. The department has said it is working administratively to strengthen its nexus standard based on recent court decisions. Also, some people have argued that the throwback rule is inconsistent with the state's increasing emphasis on sales in determining SBT taxes. It makes no sense, say critics, to reduce the use of the property and payroll factors but then employ a throwback rule that taxes companies based on their presence in Michigan.

Against:

This bill ought to be accompanied by legislation that would put into statute a stronger nexus standard for the Department of Treasury to use in taxing business activities of out-of-state companies. That would reduce the revenue impact from this proposal. This should not be left for the department to carry out administratively.

POSITIONS:

Among those indicating support for the bill before the House Tax Policy Committee on 10-15-97 were:

- The Michigan Department of Treasury
- The Michigan Chamber of Commerce
- The Michigan Manufacturers Association
- Masco Corporation

Analyst: C. Couch

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.