The Unitary Business Principle Applies To More Than Net Income Taxes

by Paul H. Frankel, Craig B. Fields, Michael A. Pearl, and Richard C. Call

Recently, in Reynolds Metals Co. v. Department of Treasury, the Michigan Court of Appeals held that the unitary business principle applies to Michigan’s single business tax. Although the court’s decision comes as no surprise, it is significant because it reinforces the fact that the unitary business principle applies to more than corporate net income taxes; for example, it applies to gross receipts taxes or value added taxes as well. Long before corporate net income taxes were commonly used by states, the U.S. Supreme Court developed the rationale of a unitary business to ensure that a state did not tax value or activity occurring outside the state. That rationale applies equally to VATs, gross receipts taxes, net worth taxes, or other business activity taxes. In the following pages, we review and analyze the court’s decision and discuss its application to taxes other than the SBT.

The Michigan Court of Appeals Holds That Michigan May Not Tax the Gain on the Sale of a Nonunitary Entity

The SBT, which was repealed for all years after 2007, is a VAT that uses the federal income tax system as its starting point. The taxpayer then makes various required additions and subtractions to federal taxable income to convert the base into a consumption-type VAT base (the SBT tax base).

Reynolds Metals Co. is a manufacturer, distributor, and marketer of aluminum products. At issue in Reynolds Metals was the Michigan Court of Claims’ decision that precluded the state Department of Treasury from including in the SBT tax base capital gains recognized by Reynolds Metals from the sale of an interest in a foreign joint venture that was based in Australia. The foreign joint venture was established by Reynolds Metals and three other aluminum companies for the mining and refining of alumina, a product used to produce aluminum.

The Michigan Court of Appeals sustained the lower court’s decision that the capital gains were not includable in the SBT tax base. The evidence showed that no functional integration existed, because there was no sharing of managerial or operational resources between Reynolds Metals and the joint venture and no sharing of research and development; Reynolds Metals was unable to control the joint venture; and transactions and agreements between Reynolds Metals and the joint venture were negotiated at arm’s length. Reynolds Metals and the foreign joint venture did not have centralized management because Reynolds Metals had less than a majority control of the foreign joint venture’s executive committee (comparable to a board of directors), and day-to-day operations were run by an independent management company that had its own facilities, resources, employees, and accounts and that reported to the executive committee. Finally, no economies of scale were present because no joint purchasing or production occurred and any alumina produced by the joint venture and sold to Reynolds Metals was sold at arm’s length.

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1Paul H. Frankel of Morrison & Foerster LLP argued the case before the Michigan Court of Appeals. Patrick R. Van Tiffin, a partner in the Oakland County office of Honigman Miller Schwartz and Cohn LLP, served as local counsel in the case.


4Id. at 496-497 (footnote omitted).
The Michigan Court of Appeals Affirms That the Unitary Business Principle Applies to Michigan’s SBT

In sustaining the lower court’s decision, the Michigan Court of Appeals rejected the department’s argument that the unitary business principle does not apply to the SBT. The department based its argument on two premises: (1) “the unitary business principal [sic] is not applicable to the SBT because the SBT is a value-added tax, and no court has ever ruled that the unitary business principal [sic] is applicable to value-added taxes”; and (2) prior Michigan case law had held that the unitary business principle does not apply to the SBT. The first argument is addressed below.6

In holding that the unitary business principle applies to the SBT, the appeals court addressed the nature of a VAT, stating that “value-added taxes are designed to measure and tax the activity and contribution an economic enterprise adds to the economy, as opposed to an income tax, which taxes the return received from supplying those resources to the economy.”7 The court then explained that “in Mobil Oil Corp., the United States Supreme Court reiterated that a state may not tax value earned outside of its borders; however, businesses operating in interstate commerce are not immune from fairly apportioned state taxation.”8 Further, “for purposes of satisfying the Due Process Clause, ‘the linchpin of apportionability in the field of state income taxation is the unitary-business principle.’”9 The court of appeals then stated:

While the unitary business principle is frequently applied to test the constitutionality of the apportionment of income-based taxes, no case has held that the unitary business principle is only applicable to income-based taxes; nor would such a holding reasonably follow from the line of cases applying the unitary business principle.10

The Michigan Court of Appeals relied in part on the U.S. Supreme Court’s description of the SBT in Trinova Corp., in which the Supreme Court held that the SBT was constitutional. In Trinova, “the Court explained that in the case of both value-added taxes and income-based taxes, the ‘discrete components’ of a state tax ‘may appear in isolation susceptible of geographic designation.’”11 However, “the Court recognized the impracticality of assuming that all income can be assigned to a single source” and noted that “added value often cannot be assigned to a single source” because of “factors such as functional integration, centralization of management, and economies of scale.”12

Based on the above rationale, the Michigan Court of Appeals concluded:

The unitary business principle applies to value-added taxes, such as the SBT, because the underlying realities of both income-based and value-added taxes require apportionment, and the United States Supreme Court has made it clear that the apportionment of taxes is constitutionally permitted only if the business is unitary.13

U.S. Supreme Court Precedent Confirms That the Unitary Business Principle Applies to VATs

The court of appeals correctly decided Reynolds Metals: The unitary business principle does apply to the SBT. For similar reasons, the unitary business principle should apply to other apportioned state taxes that are not corporate net income taxes, such as gross receipts taxes, net worth taxes, and business activity taxes.

The Supreme Court explained that the unitary business principle is a constitutional restraint ‘on a State’s power to tax value earned outside its borders.’

The court’s holding is consistent with Complete Auto, which summarized the U.S. Supreme Court’s analytical framework for evaluating the constitutional state of taxes as follows:

- the tax is applied to an activity with a substantial nexus with the taxing state;
- the tax is fairly apportioned;14
- the tax does not discriminate against interstate commerce; and

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6The Michigan Court of Appeals dismissed the second argument because the case on which the department relied held that the unitary business principle did not apply to multiple entities to be treated as one taxpayer, notwithstanding whether the unitary business principle limits what income of a multistate corporation may be taxed. Id. at *10 (emphasis added).
7Id. at *10 (internal citation omitted) (citing Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 436 (1980)).
8Id. at *14.
9Id. at *13.
10Id. at *14.
11Id. at *14 (citing Trinova Corp. v. Mich. Dep’t of Treasury, 498 U.S. 358, 377-378 (1991)).
12Id. at *14-*15 (citing Trinova Corp., 498 U.S. at 378-379).
13Id. at *15.
net income taxes. Taxpayers seeking to argue that the unitary business principle applies to more than corporate net income taxes may find its rationale applicable to their situations. This topic is relevant because some states have adopted taxes other than corporate net income taxes and others have considered adopting such taxes. In fact, since Michigan repealed the SBT, Michigan has adopted two new taxes. The first was in the Michigan Business Tax Act, which consisted of a corporate net income tax and a gross receipts tax, and the second is a more traditional corporate income tax. Other states such as Ohio, Texas, and Washington also have business activity or gross receipts taxes in lieu of corporate net income taxes. And some states impose franchise or net worth taxes that seek to tax an apportioned share of a multistate taxpayer’s value.

To the extent that taxes other than corporate net income taxes are imposed on a multistate business, the U.S. Constitution requires apportionment as well as the application of the unitary business principle to those taxes. In some cases, state law explicitly recognizes this fact. For example, the Texas statutes regarding the Texas margin tax explicitly recognize the unitary business principle for purposes of combined reporting. Nevertheless, specific fact patterns may arise in which a state taxing authority argues that the unitary business principle does not apply. Thus, Reynolds Metals and the Supreme Court cases described above provide a helpful framework from which to rebut those arguments.

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29 Texas Tax Code section 171.0001; 171.1014; Texas Admin. Code section 3.587.