1976


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NOTES

THE MICHIGAN SINGLE BUSINESS TAX ACT:
A BLUEPRINT FOR OHIO?

On August 27, 1975, the Michigan Single Business Tax Act (SBTA) took effect. The SBTA, in conjunction with several other acts, represented a comprehensive effort by the Michigan legislature to revise the scheme for the taxation of business activity within the state.

This note will explore some of the major provisions of the SBTA, focusing upon those areas Michigan has treated in a manner different from that of other states. Initially, the various types of state business taxes will be introduced. Each tax's strengths and weaknesses will be explored so that the SBTA can be evaluated in relation to the other types of taxes the Michigan legislature might have chosen. Next, the note will address the problem of the allocation of income of multistate businesses. There are also the questions of how to define "taxable income" and the "persons" to be taxed. The SBTA responds to those questions with new and very different concepts. Finally, the strengths and weaknesses of the SBTA in each of these areas will be compared with the Ohio scheme of business taxation and, to some extent, the federal income tax. Hopefully, this comparison will reveal some of the deficiencies in the Ohio tax and, ultimately, answer the question of whether or not a tax such as the SBTA is suitable for use in Ohio and other states.


2 Mich. Comp. Laws Ann. §§ 205.131-.144 (Supp. 1976) (property owned by persons subject to SBTA exempted from the intangibles tax); id. §§ 450.304-.310 (repealed the state franchise fee for corporations); id. §§ 489.842, .852, .879 (repealed privilege tax on savings and loan associations); id. §§ 500.443-.449 (repealed privilege tax on insurance companies); Mich. Pub. Acts of 1975, No. 232 (codified in scattered portions of Mich. Comp. Laws Ann. § 206 (Supp. 1976)) (repealed the income tax on corporations and financial institutions; individuals, estates, and trusts that remain subject to the income tax are allowed a credit for any SBTA tax paid); Mich. Comp. Laws Ann. § 211.9c (Supp. 1976) (exempted inventories from the general property tax); id. § 207.5a (excluded materials and supplies from the definition of "property" for the purposes of the general property tax).


4 At least one author has recognized that Ohio and Michigan are in direct competition for new industry and that the scheme of taxation may determine which state can attract more industry over the long run. Ward, A C.P.A. Examines Michigan's Tax Structures, 34 Mich. St. B.J. 34, 40 (Jan. 1955).

In addition to being in close proximity to each other, Ohio and Michigan are very similar in population, urbanization, personal income, manufacturing, and other statistical characteristics. See U.S. Dept. Of Commerce, Statistical Abstract of the United States 12, 19, 380-81, 730, 731 (1974).

5 While the constitutionality of the SBTA is beyond the scope of this note, there have been so many challenges to state taxes that some introduction is necessary. The early constitutional challenges usually focused on whether the state had the power to tax at all, e.g., Ohio Life Ins. & Trust Co. v. DeBolt, 57 U.S. (16 How.) 416 (1853); Robertson v.
I. INTRODUCTION TO THE STATE TAXATION OF BUSINESS

A. The Types of State Business Taxes

It is perhaps trite to note that state legislatures have become remarkably proficient at devising new methods to tax their state's businesses. Real property, personal property, intangibles, organization, franchise, gross receipts, and income taxes are all commonplace. Unfortunately, most of these taxes were imposed to raise revenue rather than out of a desire to enact an orderly plan for the taxation of business. If, however, a state legislature were considering the repeal of existing business taxes and the imposition of one well-designed tax, how would it select the one to be used? It would seem that the theoretical bases of various taxes should be compared first, to find the ones that are most equitable. Practical considerations such as efficiency of administration and ability to raise revenue will then help to sharpen the analysis.

In 1776, Adam Smith set forth four maxims by which taxes may be evaluated. Though two-hundred years old, they still provide general practical and theoretical ideals against which almost any type of tax can be evaluated. The first, equality, means that the tax should be proportionate to the income of the taxpayer. The second, certainty, requires that the taxpayer have advance knowledge of when and how a tax will be levied. Convenience of payment is the third maxim. Fourth is economy of collection and enforcement. A. SMITH, THE WEALTH OF NATIONS (1937). In recent years the first of these maxims, equality, has become the focal point for the discussion of taxes. It can be broken down into two subgroups — vertical equality (progressive, regressive, or neutral taxation) and horizontal equality (among groups, classes, industries, regions, etc.). The emerging test in the area has become "ability-to-pay." The policy is that everyone should contribute in relation to their ability to pay. It is only fair to expect one to pay what he reasonably can pay out of his current income, even if that is less than a per capita allocation of the costs would require. The practical problem with the theory is that it precludes almost every form of taxation other than an income tax. Only an income tax measures one's ability to pay over a given period of time, given that taxes are to be paid out of current income. Other taxes, especially property taxes, are often levied irrespective of ability to pay in a given year; rather, they are based upon the accumulated wealth of prior years.

Commissioner of State Land Office, 44 Mich. 274, 6 N.W. 659 (1880); whether the statute has been applied equally and uniformly, Cummings v. Merchant's Nat'l Bank, 101 U.S. 153 (1879); whether imposition of the tax results in double taxation, Leader v. Glander, 149 Ohio St. 1, 77 N.E.2d 69 (1948); Shapero v. Department of Revenue, 322 Mich. 124, 33 N.W.2d 729 (1948). More recently, taxpayers have questioned whether a state can tax businesses in interstate commerce, e.g., Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959); Note, Developments in the Law: Federal Limitations on State Taxation of Interstate Business, 75 HARV. L. REV. 953, 956-71 (1962), and if so, how the activities of multistate businesses are to be allocated to a particular state for tax purposes, Hellerstein, Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business, 21 NAT'L TAX J. 487 (1968).

An overview of the development and resolution of these challenges is provided in two casebooks. J. HELLERSTEIN, STATE AND LOCAL TAXATION — CASES AND MATERIALS 36-69 (3d ed. 1969); O. OLDMAN & F. SCHÖETTLE, STATE AND LOCAL TAXES AND FINANCE — TEXT, PROBLEMS AND CASES 51-68 (1974).

The effect of the Michigan Constitution on the SBTA is discussed in note 77 infra.

its net worth (certain franchise taxes); the value it adds to the economy (value-added taxes); and even its very right to exist (organization taxes and certain minimum-payment franchise taxes).\(^7\)

Each of these types of taxes can be evaluated in light of Smith's maxims;\(^8\) however, because of their deficiencies some of them may be dismissed rather quickly. In its pure form, the value-added tax is relatively unknown in the United States. Though it has some theoretical appeal, legislatures' unfamiliarity with it, and its disputed effectiveness in the countries presently using it, have not made this a viable alternative.\(^9\) Organization and minimum-payment taxes have limited appeal because of their limited revenue-raising abilities.\(^10\) The property tax, though probably the oldest form of taxation, has been the subject of loud and persistent criticism on both practical and theoretical grounds.\(^11\) In recent years, it has become the primary financing tool of local governments,\(^12\) and state governments appear to have abandoned its widespread use. Furthermore, whatever the tax's weaknesses in general, it seems to be especially deficient in raising revenue from businesses.\(^13\)

Having eliminated the above taxes as alternatives, a legislature seeking to tax businesses would be left with gross receipts, franchise, and

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\(^7\) Some theorists would add sales taxes to this list. They have been excluded here because they are taxes imposed upon the customer, not the business. Nevertheless, some economists argue that the true incidence of the taxes is upon the business, not the customer. D. Morgan, *Sales and Income Taxes*, in *State and Local Finance* 116-19 (W. Mitchell & I. Walter ed. 1970).

\(^8\) There is extensive literature making such comparisons covering the economic, political, business, and legal viewpoints. Some introduction to it will be provided in the discussion of each type of tax.


\(^10\) States generally seek to keep organization taxes low in order to attract new industry. Even if they were higher, they provide only a one-time source of revenue. Minimum-payment taxes (usually imposed on corporations in the form of a minimum franchise tax) must be set low enough to attract new industry and not to preclude the corporate form of organization for small businesses.


\(^12\) See D. Netzer, *Economics of the Property Tax* 9-10 (1966).

\(^13\) If the property tax were the sole means of taxation, there would be hundreds of businesses that would pay relatively little tax. Any company or industry with little or no property would pay little or no tax regardless of its income or ability to pay (e.g., law offices). On the other hand, companies with many plants or large amounts of equipment would be heavily taxed irrespective of ability to pay (e.g., utilities, real estate holding companies). Because of this problem, the property tax on businesses is especially vulnerable to attack on the basis of Smith's equality maxim. Most of the property tax reform literature deals with the equality problem. Recently, however, certainty and economy of collection have become a problem as well. This has been due to the frequent property value reassessments necessitated by rapidly changing land values.
of businesses can be criticized on the ground of Smith's first maxim, equality. The tax falls heavily on certain types of businesses without regard for their ability to pay. Since it probably meets Smith's other maxims as well as the income tax, perhaps it has been this lack of equality that has made the gross receipts tax a rarity.

The second most popular form for the taxation of businesses is the capital value or franchise tax. These taxes assume various forms but most have one thing in common — they are aimed at the equity section of the corporate balance sheet. They seek to tax the capital of the corporation.

As used in this note, a gross receipts tax is a tax based on the gross receipts of the business. It is distinguished from a sales tax, which is also based on gross receipts, but is paid by the purchaser of the business' goods rather than the business itself. The terms gross receipts tax and sales tax are often used interchangeably, especially in statutes, but they represent distinct concepts.

An example will suffice. Taxpayer A operates a high-volume, low profit margin business, and B deals in low volume with a high profit margin, both selling identical products. Each has no overhead, generates the same net profit before state taxes and faces a 5% gross receipts tax. Their income statements for 19X1 appear thus:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$500,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>450,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Profit</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Gross Receipts Tax @ 5%</td>
<td>25,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Profit After Tax</td>
<td>$ 25,000</td>
<td>$ 45,000</td>
</tr>
</tbody>
</table>

Both have an equal ability to pay (profit before tax), both have contributed the same profit to the state's economy and yet A, by virtue of the nature of his operation, pays a significantly higher tax. The fairness problem is patent. Not only does this type of tax discourage the development of individual companies similar to A, it falls especially heavily on certain industries that operate as A does, e.g., supermarkets and discount retailers.

Papke, Indiana Tax Policy: Revision, Reform, Reconstruction, 17 Nat'l Tax J. 113, 115-23 (1964) gives a more detailed critique of gross receipts taxes from an economist's point of view.

The concept of ability to pay is developed as a part of Smith's equality maxim in note 6 supra.

Regarding determination, collection, and enforcement, the income and gross receipts taxes are very similar. Both rely on selective enforcement and self-assessment.

Only seven states impose a true gross receipts tax. See P-H State and Local Taxes, All States Unit ¶ 200 (1976). A number of other states impose such taxes but only on certain industries, principally public utilities.

38 states presently impose a tax on the privilege of being or of operating a corporation within the state. See P-H State and Local Taxes, All States Unit ¶ 101 (1975).

Frequent bases for the tax are Capital Stock, Paid-in Capital and Retained Earnings, in various combinations. These are discussed very generally in P-H State and Local Taxes, All States Unit ¶¶ 92,280-318 (1965).

It is interesting to note that franchise taxes were developed at a time when corporations were valued for investment purposes by their balance sheet values. As security analysts became more sophisticated and as inflation distorted the balance sheet, the focus for valuation became the income statement. Today, security analysts value the corporation almost wholly on its earning capacity with little regard for balance sheet values, except in a liquidation situation. See B. Graham, D. Dodd & S. Cottle, Security Analysis — Principles and Technique 434-37 (4th ed. 1962). By the early 1940's, courts recognized the inadequacy of balance sheet valuation, see e.g., Consolidated Rock Prod. Co. v.
Like the gross receipts tax, the franchise tax's major theoretical failing is its lack of equality. It taxes certain businesses more heavily because of the form and structure of the corporation and the requirements of the industry. Thus, when this tax is large enough to be significant, the form and structure of the corporation become the focus of the company's tax planners. Those businesses which, because of business or industry constraints, are restricted to certain forms or structures, must pay the tax without regard for their ability to pay. Furthermore, the franchise tax has certain practical problems. By its nature and in practice, the tax cannot be effectively levied against unincorporated businesses which, in most states, represent a lucrative tax base. Additionally, unless the tax is carefully designed, it may not share in the growth of the corporation and thus, the tax base may erode during inflationary periods. The bases upon which the tax is usually defended are theoretically questionable in light of the operation of the modern corporation.

Du Bois, 312 U.S. 510, 525-27 (1941), however, even in the 1970's the states are still taxing the balance sheet (franchise taxes) rather than the income statement.

The concepts of equality and ability to pay are developed in note 6 supra.

Some indication of how businesses have been able to avoid the tax is shown by P-H State and Local Taxes, All States Unit ¶¶ 92,220-242 (1965).

The burden of franchise taxes is especially heavy on those corporations which are equity financed rather than debt financed. Those that are debt financed have proportionately less equity and, thus, a smaller franchise tax base. Utilities are frequently organized in this fashion. For those businesses which must be equity financed, due to the nature of the business, the franchise tax is an unavoidable burden. These businesses usually have little debt financing because of a lack of physical assets to secure such debt. Service industries and small businesses in general are examples. The economic problems in taxing net worth (equity) are developed in Thurow, Net Worth Taxes, 25 Nat'l Tax J. 417 (1972).

Entire industries are dominated by unincorporated businesses. Law firms and real estate holding companies are examples.

A franchise tax levied solely on Capital Stock and Paid-in Capital may have the same tax base throughout the life of the corporation if the corporation never issues any additional stock. The state only shares in the growth of the corporation to the extent of new stock issued. Income taxes, on the other hand, participate in the growth to the extent of increased profits, even if those profits are only the result of inflated price levels. Broader based franchise taxes that include Retained Earnings in the tax base may share in the growth of the corporation, depending on the tax's structure and the company's policy on dividend payments.

The responsiveness of state taxes to economic growth is not easily determined because of the peculiarity of each state's taxes. One study did note, however, that Michigan's corporation taxes were particularly unresponsive to economic growth. See Legler & Shapiro, The Responsiveness of State Tax Revenue to Economic Growth, 21 Nat'l Tax J. 46, 51 (1968). Interestingly, the study covered the years 1945-64, when Michigan did not have a true corporate income tax, but had several other forms of taxation. See notes 73-81 infra and accompanying text.

The franchise tax is frequently defended on the grounds that it provides assured revenues in the face of a failing economy, when the revenues from an income tax would fall as profits fell. This depends on the structure of the tax and its responsiveness to changes in the state's economy. See Legler & Shapiro. The Responsiveness of State Tax Revenue to Economic Growth, 21 Nat'l Tax J. 46, 51 (1968). If the franchise tax is less responsive to growth in the state's economy, it would follow that its base would probably not erode as quickly in a failing economy. There appears to be a trade-off involved here. If the tax is more responsive to growth in the economy, it follows that the base will probably erode more rapidly in a failing economy. Conversely, less responsive taxes, such as
Because of some or all of the deficiencies in the other forms of business taxation, the income tax has become the most popular.\textsuperscript{28} While 35 states still impose a franchise tax along with an income tax,\textsuperscript{29} 12 states, Michigan being the latest to follow suit, impose the income tax alone.\textsuperscript{30} The Michigan approach is noteworthy because the legislature, in reconsidering the entire business taxation scheme, voted to repeal the franchise tax and to rely principally on the income-based SBTA.\textsuperscript{31} What, then, is the appeal of an income tax?\textsuperscript{32}

Perhaps the basic theoretical appeal of the income tax lies in its equality for the business taxpayer. An income tax pays no heed to business form or structure, how much capital or property it owns, or the nature or amount of its gross receipts. The tax asks only one question: How much can this business contribute from current income to defray the cost of running the state? It answers with a fixed percentage of net income levied on every business irrespective of the factors just mentioned. In its pure form, it taxes solely on the basis of ability to pay. Furthermore, it taxes at the same rate whether the business is incorporated or unincorporated.\textsuperscript{32} Thus, it appears the income tax meets Smith's equality maxim because of its adherence to the ability to pay principle.\textsuperscript{33}

The income tax also appears to meet Smith's certainty and convenience of payment maxims. It is doubtful that any modern tax would fail the certainty test in the context in which Smith developed it.\textsuperscript{34}

the franchise tax, will probably remain more stable during periods of growth or recession (assuming it is true that the franchise tax is, in fact, less responsive). However, this "stickiness" of the franchise tax further accentuates its lack of regard for ability to pay. As the economy falters and firms make less money, the tax continues at high levels despite the change in ability to pay.

Other defenses of the franchise tax are that corporations should pay for the use of state services and for the privilege of holding the franchise. There are only two times during the corporation's existence when there is necessarily a direct use of the state's services: at the corporation's inception and at dissolution. The franchise tax burden bears no relationship to either of these events. The policy of taxing the privilege of holding the franchise is inconsistent with legislatures' policy of granting the "privilege" as freely as possible in order to attract new business to the state. Both of these justifications for the tax seem to belie the tax's true purpose—to raise revenues.

\textsuperscript{28} Forty-six states now impose a corporate income tax. \textit{See} P-H \textsc{State and Local Taxes, All States Unit \& 101} (1975).

\textsuperscript{29} Id.

\textsuperscript{30} Id.

\textsuperscript{31} A wide variety of taxes were repealed with the passage of the SBTA leaving it the primary business-oriented tax. \textit{See} note 2 supra.

\textsuperscript{32} The imposition of a state income tax on unincorporated businesses is still relatively rare. Michigan, however, under the SBTA, does impose a tax on these entities. \textit{See} notes 135-59 infra and accompanying text.

\textsuperscript{33} \textit{See} note 6 supra.

\textsuperscript{34} With the wide publicity given to tax statutes and the enormous amount of literature on all types of taxes, one could conceivably compute any tax liability. The complexity of the computations is another question. If Smith's certainty maxim were read to require that every taxpayer know its liability precisely, the income tax would probably fail because of its complexity. However, there is nothing inherent in an income tax that requires complexity. It could be very simple; it is for political, economic, and administrative reasons that the income tax is complicated by additional provisions. \textit{See} J. Chommie, \textsc{The Law of Federal Income Taxation \& 5} (2d ed. 1973).

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The convenience of the income tax derives from its method of payment, that is, either quarterly\textsuperscript{35} or annually along with the other expenses of the business. Again, however, most modern taxes would probably meet the convenience of payment test.\textsuperscript{36} The income tax meets the economy of collection maxim as well as or better than other taxes, because it is based on self-assessment. In theory, each taxpaying entity computes its own tax and remits it to the state. Unlike the property tax, which requires assessment and billing by the state before the taxpayer pays, the income tax requires no action on the part of the state to initiate the collection process.\textsuperscript{37}

The income tax's one failing is an economy of enforcement. It is very difficult to locate every income-generating business that should be paying taxes to the state. Many of them are simply too small or have so little contact with the state that their existence is difficult to determine. Often those subject to the income tax will not register with the state because they make only occasional sales within the state. In this respect, the property and franchise taxes are clearly superior. The property tax is superior because it is virtually impossible to acquire or hold land without recording it with the state. Likewise, for business and non-tax legal reasons, virtually all corporations covered by the franchise tax will register with the state, thereby subjecting themselves to the tax.

Thus, on the whole, the business income tax appears to meet Smith's maxims better than any other viable means of taxation. Its one deficiency, difficulty of enforcement, is outweighed by its clear superiority in meeting the maxim of equality.

B. The Problems of Multistate Income Allocation

During the 1950's, the individual states began to levy taxes on business income. This immediately raised the question of how businesses which operated in more than one state were to allocate their income among the states. The question was litigated,\textsuperscript{38} legislation was introduced in Congress,\textsuperscript{39} and a uniform law was adopted,\textsuperscript{40} yet there was

\textsuperscript{35} Quarterly estimated tax payments are required by the SBTA. \textit{Mich. Comp. Laws Ann. }§ 208.71 (Supp. 1976).

\textsuperscript{36} Most taxes require only a single payment to a single taxing authority either annually, semi-annually, or quarterly.

\textsuperscript{37} There is little conclusive, empirical evidence on the cost of collection and compliance with state taxes. The property tax probably places most of the burden on the state (valuation, assessment, billing, and collection), while the income tax places it on the taxpayer (self-assessment and selective enforcement). One study of the cost of compliance concluded that in Montana the total costs for income and property taxes were roughly equal. Wicks & Killworth, \textit{Administrative and Compliance Costs of State and Local Taxes, }20 \textit{Nat'l Tax J. }309, 315 (1967).

\textsuperscript{38} The litigation culminated in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959), which held that states could apportion the income of, and levy taxes upon, the interstate activities of multistate businesses if the taxes imposed were non-discriminatory and the apportionment had a reasonable relationship to the businesses' activities in the taxing state.

\textsuperscript{39} A brief and informative history of the development of the allocation problem, including major legislative proposals, is provided in \textit{P-H State and Local Taxes, All States Unit }§ 5100 (1968).

\textsuperscript{40} \textit{Uniform Division of Income for Tax Purposes Act, }7 \textit{Uniform Laws Ann. }365
no satisfactory answer to the problem. Finally, in 1967, the Multistate Tax Compact (MTC)\(^{41}\) was developed\(^{42}\) and 36 states presently subscribe to it.\(^{43}\) Since the MTC’s adoption and general acceptance, the question of income allocation has not enjoyed the notoriety it once did, though there is still some discussion of the practical aspects of its application.

Literature on multistate income allocation is plentiful\(^{44}\) and it is not the purpose of this note to add to it. Rather, a brief introduction to the MTC, its problems and advantages, will be presented. Specific reference can then be made to the Michigan and Ohio statutes to show how those states have resolved the allocation problem.\(^{45}\)

It is important to note that deviations from the MTC must be closely examined in view of the need for uniformity among the states in order to be fair to the taxpayer. The results of inconsistent or incorrect allocation of multistate business income are easily illustrated.\(^{46}\) The obvious result is that if too much or too little taxable income is allocated to a particular state, it will have a larger or smaller tax base than is consistent with the taxpayer’s level of business operations within the state. Clearly, with a wide range of allocation methods available, legislatures would be inclined to adopt the one providing the largest tax base for

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\(^{41}\) The MTC subsumed the UDITPA and provided a comprehensive scheme of allocation with a detailed set of regulations and procedures for changing them. The MTC is administered by the Multistate Tax Commission, whose duties and powers are defined by the Act itself. The current version of the Act is contained in P-H State and Local Taxes, All States Unit ¶¶ 6310-68 (1976). The regulations are found at id. ¶¶ 5920-6286.

\(^{42}\) See note 39 supra.

\(^{43}\) P-H State and Local Taxes, All States Unit ¶¶ 5150, 5151 (1976). Fourteen of the thirty-six states are “associate members.” They are distinguished by the fact that they do not have a voting membership on the Multistate Tax Commission. Nevertheless, all 36 states substantially follow the MTC. Illinois and New York, both members at one time, have withdrawn. Id.

\(^{44}\) A series of six articles collected in 18 Ohio St. L.J. 1-104 (1957) shows the breadth of the allocation problem. An overview of the whole area and an introduction to the now prevalent three-factor formula is presented in Lynn, Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum, id. at 84.


\(^{45}\) The federal government need not deal with the allocation problem since it taxes all United States income regardless of the state wherein it was earned. It does, however, face a conceptually similar problem in dealing with taxpayers with income from foreign countries.

\(^{46}\) The illustrations herein are an expansion of the points raised in Wilkie, A Basis for Taxing Corporate Net Income, 36 Taxes 807, 808-09 (1958). See also Pierce, Uniform Act Urged as Practical Method to Lighten State Tax Compliance Burden, 12 J. Tax. 83 (1960).
their state. While this would undoubtedly be beneficial to the particular state, it can result in a given taxpayer being subjected to several states' taxes disproportionate to its operations within those states and on more than 100% of its income.\textsuperscript{47} Thus, whatever method is chosen, all states should subscribe to it. In this way, each state is assured of receiving the revenue it deserves, and 100% of the taxpayer's income will be subject to taxation, but no more. Of course, this requires that the individual states compromise their desire to maximize their revenues in order to be fair to the individual taxpayer.

In addition, the prevalence of interstate commerce raises the question: Should the income of businesses engaging in interstate commerce be taxed where the sale originates; where it is completed; in states through which the goods pass; or where the company maintains its headquarters? All of these locations provide a legitimate basis for a state to tax income. As illustrated, the income of a single interstate business could be fully taxed in at least four states resulting in the business paying tax on 400% of its income from a particular transaction. Since it is obvious that the taxpayer should be taxed on 100% of its interstate income, but no more, income should be allocated among the states in some reasonable fashion.

The lack of a uniform system also leads to overly burdensome reporting requirements and consequently high administrative costs. The multistate taxpayer must comply with as many as 51 systems of allocation, each with its own forms, reports, and regulations. Additionally, the taxpayer is motivated to plan its business activities to lessen the total impact of state taxes by "allocating" the largest part of its income to the state which will tax it least. The need for such efforts would be reduced if all states adopted the same allocation method.

Finally, lack of a uniform system fosters litigation among the states and between taxpayers and the states. Such litigation could be sharply reduced if all states subscribed to the same plan. All of these problems are resolved by a uniform act such as the MTC.

Mechanically, the MTC allocates income through the use of the "three-factor formula". Basically, the formula allocates income among the states based upon the weighted average of the payroll, sales, and property located within the given state in relation to that located in all other states. If all states followed the MTC, all of a taxpayer's income would be allocated to some state, but a maximum of 100% would be subject to taxation by the various states. It is important to remember, however, that the MTC only allocates income among the states; each state is free to tax that income as it chooses.

\textsuperscript{47} If the taxpayer operates in three states, A, B, and C, and each uses a different method of allocation, theoretically, there is nothing to protect the taxpayer from having to pay taxes on more than 100% of its income. Under A's method 60% of the taxpayer's income could be allocated to that state, B-30%, and C-20%. A total of 110% of the taxpayer's income would be subject to taxation. This is clearly unfair to the taxpayer and yet it can easily happen when states use inconsistent allocation methods and all seek to maximize their revenues. Conversely, the states may inadvertently choose methods taxing less than 100% of a taxpayer's total income, thus depriving themselves of revenue which they rightfully deserve.
The MTC property factor is based upon property valued at original cost. While depreciated value could have been used as the basis, the selection of original cost avoids the problem of evaluating widely varying methods of depreciation among companies as well as dealing with such nebulous concepts as replacement cost and fair market value. Though in certain circumstances original cost can result in unusually high or low allocations to a particular state, the practical problems of the other bases seem to far outweigh the theoretical problems encountered with the cost basis.

The cost of property within a state is determined by averaging the value of the property at the beginning and end of the tax year. While this method is relatively easy for the Commissioner to administer, valuation at only two dates per year opens the door to abuses by certain industries. It would seem that an average taken on a monthly basis would be almost as easy to administer and yet would effectively curb such abuses.

The property factor also takes into account property rented or leased by the taxpayer. Such property enters into the computation by valuation at eight times the annual rental cost, less any sub-rental income. This provision recognizes the fact that leasing is a common method of financing business activities and that long-term leasing is, in effect, a purchase of the leased equipment. The inclusion of rental property is

48 P-H State and Local Taxes, All States Unit ¶ 6325 (1975).
49 For example, a large plant constructed in state A in 1960 might have originally cost $1,000,000. The same plant constructed in state B in 1976 might cost $1,500,000, due to inflation. This company's property factor would allocate more income to state B even though the plants are identical, except for their age and cost. The problem could be avoided if replacement cost were used as a basis for the property factor. This would presumably set the value of the plant in A at $1,500,000 (the cost to replace it in 1976). As a practical matter, replacement cost is difficult to determine and necessarily involves a subjective evaluation. Further, it only changes the allocation among the states, not in total. Nevertheless, cost basis allocation in periods of rising prices does allocate a larger portion of income to states which, on the whole, have newer, more expensive plants and equipment. This favors those states with newer, developing industries rather than those with older, more stable industries. It results in an anomaly in that those states that are already expanding are allocated more income than those that have reached a more mature stage in their growth cycle.

50 UDITPA § 12.
51 Companies with very expensive, mobile equipment would be motivated to move the equipment out of the state for the dates of determination. For instance, a construction company near the Michigan border could move a number of its cranes, trucks, and tractors across the border into Indiana from December 29 to January 2 of each year. If Indiana does not use a property factor or if it taxes at a lower rate, such an annual trek could prove quite fruitful.
52 While the type of movement described in the previous footnote may be feasible once a year, this method would require monthly movement. The cost and inconvenience of such movement would seem to outweigh any tax benefits that might be derived.
53 While the Commissioner has the power to use a method other than annual averages, e.g. UDITPA § 12, he would not invoke the power unless he had reason to believe the annual method was inaccurate or fraudulent. If he had such knowledge, it would seem he could show the movement to be a sham to avoid taxes, and ignore it anyway.
54 P-H State and Local Taxes, All States Unit ¶ 6325 (1975).
55 It is now a widely recognized theory of finance that leasing is simply a form of financing the use of an asset. The concept is developed in any basic text on finance.
in accord with the substance of the lease transaction, rather than its form. Thus, the taxpayer that chooses to lease a large portion of its equipment is not taxed any less than the one that chooses to purchase its equipment. The derivation of the eight times annual rental cost is unclear, but appears reasonable in relation to prevailing interest rates.56

C. The Determination of “Taxable Income”

Having elected to rely on an income tax rather than some other form of business taxation, a legislature must decide upon a definition of “taxable income”. Through its determination of what is to be included in income, the legislature gives effect to its tax policies. If there are certain types of income, certain transactions or businesses that the legislature wishes to promote, it will frequently do so by excluding such income from the definition of that which is taxable. It is this definition that determines the true shape of the tax and reflects the policies of the legislature.

Rather than develop a comprehensive statutory definition of taxable income, most states adopt the definition used for federal tax purposes, beginning the computation with the taxpayer’s income figure from its federal tax return, then making adjustments to arrive at the state’s definition of taxable income. The advantages of “piggybacking” the Internal Revenue Code in this way are severalfold.57 First, it is legislatively economical. It is far easier to embrace the time-tested federal definition of income and the body of law that surrounds it58 than to develop a new definition. Second, future disputes about the meaning of the statute that are resolved at the federal level are, by implication, re-


Because of the widespread use of lease financing, the Securities Exchange Commission now requires disclosure of the effect of certain types of leases on the financial statements of regulated companies. 5 CCH Fed. Sec. L. Rep. ¶ 72,169 (1974).

Recognizing that leasing is a method of obtaining the use of an asset, the property factor would be inaccurate if it did not recognize the leased (or rented) assets as income-producing assets of the enterprise. It does so by bringing leased property into the computation at eight times annual rental.

56 The rate of eight times annual rental implies that the cost of the leased equipment was eight times what the lessor charges for it annually. This implies a gross annual return to the lessor of 12.5% (1+8) of the cost of the asset. Such a return appears reasonable in relation to the prevailing prime interest rates, note 219 infra. A more detailed discussion of the relationship between leasing charges and interest rates is Pettway, Interest Rates on Direct Leases and Secured Term Loans, 3 Nat’l Bank. Rev. 533 (1966).


58 Mich. Comp. Laws Ann. § 208.2(2) (Supp. 1976) reads in part: “A reference in this act to the internal revenue code includes other provisions of the laws of the United States relating to federal income taxes.” This provision is apparently an attempt to embrace more than the statutory language of the Internal Revenue Code. Its reference to “laws” certainly would include court decisions and, arguably, could be expanded to include Treasury Department regulations and Internal Revenue Service rulings. Inclusion of such “law” is desirable since it is necessary to properly interpret the Code. However, a more specific provision would have clarified the Michigan legislature’s intent.
solved at the state level as well. This avoids wasteful litigation of similar issues and provides guidance on questions that otherwise might not have been raised at the state level. Third, it enables the taxpayer to plan its tax activities at the federal and state levels simultaneously. If the taxpayer secures a federal revenue ruling on the treatment of a particular income transaction or item, that ruling should, in most cases, apply to the state level as well. Although federal rulings are not binding upon a state, unless the state has a strong contrary interest, it would appear that most properly determined federal rulings would lead the state tax commissioner to a similar finding for the taxpayer. The one danger in piggybacking the federal tax is that the legislature might unintentionally adopt federal tax policies that it would not have adopted had it directly considered the issues.

D. "Persons" Subject to Taxation

All but two states impose some form of direct taxation on corporations;\(^5\) taxes on the income of estates and trusts are also common.\(^6\) Despite the pervasiveness of taxes, there is one entity that has fairly successfully avoided direct income taxation — the partnership.\(^61\) The federal income tax does not reach the partnership as an entity, except in unusual circumstances,\(^62\) because generally, a partnership is viewed as the aggregate of the individual partners and not as a separate, taxable entity.\(^63\) The income generated by the partnership flows through to the partners as individuals, and is taxed at the individual level rather than at the entity level. For the most part states have followed federal precedent and not taxed the partnership as an entity separate from its partners. There is no legal reason why states cannot tax partnerships directly. Apparently, the primary reason they have not done so is to conform with the taxing scheme of other states and the federal government. There is no theoretical problem with directly taxing partnerships according to the entity theory, under which the partnership is viewed as an entity separate from its partners.\(^64\) The practical advantage of taxing partnerships directly is that they represent a significant, very lucra-

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\(^5\) Only Nevada and South Dakota are without some direct corporate tax. See P-H State and Local Taxes, All States Unit ¶ 101 (1975).


\(^61\) Included in this discussion are those entities "taxed" like the partnership. Generally, this includes limited partnerships, joint ventures, and similar unincorporated associations.

\(^62\) Int. Rev. Code of 1954, ¶ 701. If the partnership is structured such that it has more corporate characteristics than partnership characteristics, the federal government may impose the corporate tax on the partnership despite the partnership's legal status. See Treas. Reg. §§ 301.7701-1 to -2 (1965); Treas. Reg. §§ 301.7701-3 to -4 (1960).


\(^64\) Even the federal income tax adopts an amalgamation of the entity and aggregate theories. See note 63 supra.

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tive source of revenue. Recognizing this advantage, three states do tax partnerships and, with the passage of the SBTA, Michigan became the fourth.

There is one problem posed by corporate taxpayers that is not present when dealing with partnerships. As entities separate from their shareholders, corporations can, and often do, earn large amounts of money that are not distributed to the shareholders. Distribution is independent of earnings. Thus, if there were no tax on corporate earnings when earned, only when distributed, it could be many years before the state would be able to tax the corporation's earnings. The federal government and the states have resolved this problem by imposing a tax on corporate earnings when earned. Thus, even if the income is retained in the corporation, it does not escape or delay taxation. When it is distributed it is taxed again by taxing the shareholders. The problem that arises when a corporation retains earnings to avoid the tax levied on its shareholders upon distribution is resolved for partnerships by not recognizing it as a separate taxable entity and taxing its earnings regardless of when they are distributed. Under the federal scheme and that of all but four states, partnerships are taxed according to the aggregate theory. The income is considered to be earned by the partners in their individual capacity, rather than by a separate entity. The partner is taxed on his distributive share of the partnership's profits regardless of whether the income is actually distributed. Therefore, even though partnership income may be retained at the partnership level, it is taxed to the partners as earned.

Perhaps the major reason for imposing an income tax on the partnership as an entity is that it offers a source of additional revenue. It must be remembered, however, that if a tax is imposed on the entity's net income, the amount distributed to each partner is thereby reduced and, as a consequence, their personal income tax will be reduced. In other words, a gain in tax revenue as a result of the new tax on the entity will be offset by a reduction in the revenue from the personal in-

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65 In 1971 there were 959,000 partnerships operating in the United States. They generated net profits of $9,000,000,000. In 1970 there were 35,000 partnerships operating in Michigan (36,000 in Ohio) that generated gross receipts of $2,914,000,000 ($3,022,000,000 in Ohio). U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 476-77 (1974).


67 Mich. Comp. Laws Ann. §§ 208.31(1), .6(1), .3(2) (Supp. 1976). The tax reaches only the income generated by "business activities" as defined in the SBTA.

68 Another safeguard is the direct tax on excess accumulated earnings. See Int. Rev. Code of 1954, §§ 531-37. While the prospect of this tax motivates businesses to distribute excess earnings, the tax has no effect on earnings retained for the business' use.

69 See note 63 supra.


71 See note 65 supra.

Published by EngagedScholarship@CSU, 1976
come tax. This effect may make the new entity tax less appealing than it would appear on its face. For example, assume that a partnership has a net income for 19X1 of $100,000 to be distributed to its equal partners, A and B, both of whom are in a 10% personal income tax bracket. If the partnership is not taxed as an entity, the personal income tax generates revenue from the profits of the entity of $10,000 (10% of A's $50,000 income from the partnership plus 10% of B's $50,000 income). When a 10% tax is imposed on the partnership directly, it will pay a $10,000 tax (10% of its $100,000 income) then only $90,000 is available to be taxed by the personal income tax, which would generate revenue of only $9,000. So, although the state has increased its revenue by $10,000 as a result of the partnership tax, it lost $1,000 of personal income tax revenue for a net gain of $9,000. In other words, the increase in revenue generated by a tax on partnerships as entities would not be as great as one might expect from multiplying the partnership tax rate times the net income of all partnerships operating within a given state.

II. THE MICHIGAN SINGLE BUSINESS TAX ACT

A. The Type of Tax Adopted

As early as 1921, Michigan imposed franchise taxes on corporations doing business within the state. By the 1950's, in the face of serious deficits, the legislature sought to raise additional revenue and imposed the Business Activities Tax on corporations. At that time an income tax was considered, but due to strong opposition and in light of the Michigan Constitution's prohibition against graduated taxes, the

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72 Whether there is any net gain to the state from the imposition of such a tax depends on the relative tax rates. In most cases, there will be a net revenue increase. The exception arises when the personal tax rate far exceeds (perhaps 5 to 6 times) the rate sought to be imposed on the partnership.


74 See Brazer, Michigan’s Fiscal Outlook, 11 WAYNE L. REV. 430, 431 (1965).


77 Some mention should be made of the tortured judicial history of Michigan income taxes. The problem centered around a provision in the Michigan constitution that "[n]o income tax graduated as to rate or base shall be imposed by the state or any of its subdivisions." MICH. CONST. art. 9, § 7.


There was little litigation of the provision until a taxpayer challenged the Income Tax Act of 1967, MICH. COMP. LAWS ANN. § 206 (Supp. 1976), on the grounds that credits granted for property and city income taxes paid pursuant to id. §§ 206.257-.258 indirectly made it a graduated tax and violative of the constitution. The appellate court upheld the tax stating that,
Act took the form of a value-added tax. In 1967 the Business Activities Tax was repealed in favor of the Income Tax Act of 1967 that reached individuals and estates as well as corporations. Although the 1967 income tax is still in effect as to individuals, estates, and trusts, the SBTA is now the primary tax on business activities; thus, the name ‘Single’ Business Tax.

As is apparent, Michigan has experimented with a wide variety of methods for the taxation of business. Because of this, prior to the enactment of the SBTA businesses were faced with a patchwork system of taxation which seemed to lack a common purpose or direction. The SBTA, however, represents an effort to enact a comprehensive plan
for the taxation of business and, additionally, to reduce the complexity of the state's taxes.\textsuperscript{84}

As a result of the adoption of the income-based SBTA, Michigan businesses will enjoy the benefits of an income tax rather than some other form of taxation. The primary advantage of the income tax, as developed earlier in this note,\textsuperscript{85} is its equality for the taxpayer. It taxes on the basis of the taxpayer's ability to pay and thus, it is the fairest form of taxation. Apparently, the Michigan legislature found that the advantages of the income tax outweighed those of the other taxes it could have imposed.\textsuperscript{86} Even the time-honored property tax was reduced to a relatively minor role in the overall scheme.\textsuperscript{87}

### B. Michigan's Multistate Income Allocation

#### 1. The Michigan Statute

Though it did not adopt the uniform act,\textsuperscript{88} Michigan is a member of the Multistate Tax Compact.\textsuperscript{89} Despite that membership, the SBTA varies from the MTC in several respects worthy of discussion.

For those taxpayers engaging in business activities taxable both in Michigan and in other states, the SBTA complies with the MTC\textsuperscript{90} and requires allocation based upon sales, property, and payroll. Likewise, the Michigan definition of "taxable within another state" complies with the MTC.\textsuperscript{91} Unlike the MTC, however, the SBTA also provides that,

\[
\text{[i]n the case of a taxpayer whose business activities are confined solely to this state, the entire tax base of the taxpayer shall be allocated to this state. . . . 92}
\]

\textsuperscript{84}Numerous other taxes on businesses were repealed with the passage of the SBTA. See note 2 \textit{supra}.

\textsuperscript{85}See notes 28-37 \textit{supra} and accompanying text.

\textsuperscript{86}Michigan and Ohio legislative history is almost non-existent. Ohio history consists only of notation of the action on bills in the legislative journal. The history of the Ohio Income Tax is illustrative. 134 OHIO SENATE J. 2332-33 (1971-72) (the pages referred to therein). Michigan's history consists only of notations of when the various committees met and, very generally, what they discussed. Letter from the Director, Legislative Service Bureau, Lansing, Michigan, June 3, 1976, on file in the offices of the Cleveland State Law Review. Thus, legislative intent in both states is left to speculation and reports in the press.

\textsuperscript{87}Note 2 \textit{supra}, shows the bills passed along with the SBTA. Intangibles, inventories, materials, and supplies were all exempted from the general property tax, apparently leaving only capital assets subject to it.

It should be noted that the SBTA itself refers to the nature of the SBTA as a tax on the privilege of doing business, not a tax on income. MICH. COMP. LAWS ANN. § 208.31(4) (Supp. 1976). Although this type of statement is contained in most state income tax laws to avoid constitutional problems, it is not binding on a court. The court will look to the true nature of the tax, rather than the legislature's characterization of it. P-H \textit{STATE AND LOCAL TAXES, ALL STATES} UNIT 91,105 (1982) (and footnotes).

\textsuperscript{88}See UDITPA, 7 Uniform Laws Ann. 258 (Supp. 1976).

\textsuperscript{89}P-H \textit{STATE AND LOCAL TAXES, ALL STATES} UNIT ¶ 9150 (1976).

\textsuperscript{90}Compare MICH. COMP. LAWS ANN. § 208.41 (Supp. 1976) \textit{with P-H STATE AND LOCAL TAXES, ALL STATES} UNIT ¶ 6316 (1975).

\textsuperscript{91}Compare MICH. COMP. LAWS ANN. § 208.42 (Supp. 1976) \textit{with P-H STATE AND LOCAL TAXES, ALL STATES} UNIT ¶ 6317 (1975).

\textsuperscript{92}MICH. COMP. LAWS ANN. § 208.40 (Supp. 1976) (emphasis added).
As noted above, the MTC allocates based on sales, property, and payroll within a given state in relation to other states. That definition notwithstanding, it does seem reasonable that if all of a business's activities are within Michigan, all of its income should be allocated to Michigan. A conflict becomes apparent, however, when the definition of "business activities" is consulted. The SBTA provides,

"[b]usiness activity" means a transfer of legal or equitable title to or rental of property . . . or the performance of services . . . made or engaged in . . . within this state, whether in intrastate, interstate, or foreign commerce. . . .

In other words the SBTA equates "business activity" with sales.

Apparently, this definition is an attempt by the legislature to avoid some of the constitutional attacks on past statutes. All of a business's income is allocated to Michigan if all of its sales (or services or rentals) are within Michigan, regardless of the interstate/intrastate quality of those sales.

The first problem with this is that neither the MTC nor the uniform act make such a provision, so, presumably, none of the states which follow those acts have either. Michigan has, thereby, thwarted one of the stated purposes of the MTC — to promote uniformity among the member states.

Closer analysis reveals another reason for the deviation — a larger income allocation for Michigan. The MTC allocates based upon the location of sales, property, and payroll. The fact that all sales might be within a state is of no consequence to the MTC; all three factors must be considered. With these two statutory provisions, Michigan allocates all of a business's income to the state if all of its business activities (sales or services) are rendered within the state. This ignores the possibility that the company might have property or payroll in other states and, under the MTC, would be required to allocate a portion of its income to those other states. So, although it has ostensibly complied with the MTC, Michigan has been unable to resist the temptation to maximize its revenues at the expense of fairness to the individual taxpayer.

93 Id. § 208.3(2).
94 There were numerous early cases attacking state taxes on transactions in interstate commerce. See note 5 supra.
95 See P-H State and Local Taxes, All States Unit ¶¶ 6315-32 (1975); UDITPA §§ 1-10.
96 P-H State and Local Taxes, All States Unit ¶ 6310(2) (1975).
97 These concepts are more fully developed in notes 44-56 supra and accompanying text.
99 The burden of this section falls especially heavily on companies that manufacture a product in another state, but sell solely within Michigan. They would be required to allocate 100% of their income to Michigan since all sales are within the state. Yet, if the state in which their plant is located follows the MTC, they would be required to allocate income to that state under the payroll and property factors. Once again, the individual taxpayer would be taxed on more than 100% of its income.
With the exception of the variations just discussed, the SBTA formula substantially complies with the MTC. Simply stated, income is apportioned to Michigan by applying a percentage to the taxpayer’s total income. That percentage is the weighted average of: (1) all sales within Michigan to total sales everywhere, (2) all property within Michigan to total property everywhere, and (3) all wages paid within Michigan to total wages everywhere. This is commonly referred to as the three-factor formula. According to the formula, the larger the proportion of sales, property, and payroll a given taxpayer has within Michigan, the larger the percentage of that taxpayer’s income that is allocated to the State of Michigan. The portion not allocated to Michigan is allocated to other states in proportion to the sales, property, and payroll within those states, assuming they follow the MTC. Like the MTC, the SBTA provides that if the statutory allocation results in an inequitable allocation, the taxpayer may petition for, or the Commissioner may require, the use of one of several other specified methods.

2. Michigan’s Additions to the MTC

Even though Michigan follows the MTC’s three-factor formula fairly closely, it goes beyond it in using the state’s own formula to allocate the income of certain industries. Since the MTC does not differentiate these industries, it allocates their income according to the three-factor formula. The SBTA provides that those businesses transporting people or freight shall allocate to Michigan based upon the proportion of Michigan “revenue-miles” to total revenue-miles. Likewise, pipeline oil is based upon barrel-miles; natural gas by cubic feet-miles, and insurers according to gross premiums received on risks within Michigan in relation to total gross premiums. Financial organizations allocate based upon the relation of Michigan gross business income to the total of such income.

All of these provisions are at variance with the MTC. Again, they represent an effort by the Michigan legislature to maximize its revenues at the expense of the taxpayer and in conflict with the MTC. Under the three-factor formula, it is conceivable that little or no income from these industries would be allocated to Michigan. If they only transport through the state, they would have no sales or payroll within the state and little or no property. The provisions Michigan has adopted assure

103 Id. § 208.58(1).
104 Id. § 208.58(2).
105 Id. § 208.62.
106 Id. § 208.65.
107 See P-H State and Local Taxes, All States Unit ¶¶ 6323-32 (1975). The Uniform Act made no such provisions either. See UDITPA §§ 9-18.
that by virtue of the fact that they must pass through the state, some income will be allocated to it.108

Michigan has also gone beyond the MTC in providing relief for small business taxpayers. If the taxpayer does not own or rent any property within the state and has Michigan sales of less than $100,000 during the year, the taxpayer can elect to allocate based on the sales factor alone.109 The MTC makes no such provision.110 Despite the laudable motives behind the provision, it is of questionable value. The only types of taxpayers that would sell in Michigan without owning or renting property there (thus precluding even a sales office) would appear to be mail order sellers, travelling salesmen who occasionally sell within the state, and others with the most minimal contact.111 The statute, however, does not significantly reduce the amount of effort required in order to compute the tax since the sales factor and the property factor must still be computed. Thus, the payroll computation is the only one eliminated by this provision. Since the practical savings to the taxpayer appear largely illusory, it would have been better not to have made such a provision thereby staying in compliance with the MTC.

3. Michigan's Deletion of Non-Business Income

To this point, comparison of the SBTA with the MTC has been of those SBTA sections which varied from or added to the MTC. There is, however, one section of the MTC which the SBTA completely excludes — non-business income.112

The MTC allocates business income in proportion to the factors that produce that income: sales, property, and payroll. It appears to be a reasonable assumption that business income is generated by each of these factors and, therefore, should be allocated based upon them. In addition to this theoretical basis, the factors provide a relatively practical method of allocation.

Unfortunately, the assumptions break down when dealing with non-

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108 The trucking industry is illustrative. If a certain company had routes through Michigan, but never located an office there, it would allocate no income to Michigan. It had no sales, property, or payroll within the state. Under the "revenue-miles" formula, however, some income would be allocated to the state since it clearly had such miles within the state, even if it had no property, sales, or payroll there. Note that the example is complicated if payroll can be found to be within Michigan under the statutory definition of payroll. Mich. Comp. Laws Ann. § 208.50 (Supp. 1976).

109 Id. § 208.68(1). The SBTA also provides that the election is not available for those filing a consolidated return, id. § 208.68(2), reinforcing the idea that it is directed toward the smaller taxpayer that would probably not have multiple, affiliated corporations.

110 See P-H State and Local Taxes, All States Unit ¶ 6323-32 (1975).

111 Taxpayers whose only contact with the state is the solicitation of orders, could seek protection under 15 U.S.C. §§ 381-84 (1970), which prohibits the levying of state income taxes on such taxpayers. The SBTA does not codify this provision. See P-H State and Local Taxes, Special Michigan Report ¶ 115 (1975).

112 This section of the discussion makes direct comparisons to the MTC; however, since the MTC sections were drawn from the Uniform Act, citation to both will be provided.

113 Non-business income is all income other than business income. P-H State and Local Taxes, All States Unit ¶ 6315.25 (1975); UDITPA § 1(e).
business income. This is income generated outside the scope of normal operations. It is of a passive nature, more akin to investment income than "business" income. It may have no relation to the three factors of production normally used to allocate income. For example, a manufacturing company with a plant presently unused may rent the plant to another company until such time as the owning company needs the plant. This rental income may be quite significant. It is clear that the rental income is generated by the property alone, having no relation to payroll or sales within that state. Thus, the rental income should be allocated fully to the state where the plant is located if the allocation is to reflect the economic reality of the situation. Thus, this is one case in which the three-factor formula should be dropped in favor of full allocation to the state where the property is located.

Recognizing this problem, the MTC provides that

[r]ents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute non-business income, shall be allocated [specially].114

The non-business income generated by patent and copyright royalties, and the capital gains related thereto, are allocated on a "situs" theory. Basically, the income is allocated to the state wherein the property is located, consistent with the example discussed above.115 Interest and dividend income is allocated to the state wherein the taxpayer's commercial domicile is located.116 The theory here is apparently that investment activities are conducted by the head office, principally for its benefit, and the income generated should be taxed to that office. Allocation of interest and dividends on a "situs" basis would be difficult, if not impossible.

By choosing not to adopt the MTC non-business income provision quoted above, Michigan has implicitly elected to allocate that income by the same method used to allocate business income — the three-factor formula. The precise impact of this choice is difficult to calculate.117 One positive consequence, however, is that it saves taxpayers from hav-

"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

P-H STATE AND LOCAL TAXES, ALL STATES UNIT ¶ 6315.5 (1975); UDITPA ¶ 1(a).

114 P-H STATE AND LOCAL TAXES, ALL STATES UNIT ¶ 6318 (1975); UDITPA ¶ 4.

115 See P-H STATE AND LOCAL TAXES, ALL STATES UNIT ¶¶ 6319, 6320, 6322 (1975); UDITPA ¶¶ 5, 6, 8.

116 P-H STATE AND LOCAL TAXES, ALL STATES UNIT ¶ 6321 (1975); UDITPA ¶ 7.

"Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

P-H STATE AND LOCAL TAXES, ALL STATES UNIT ¶ 6351.10 (1975); UDITPA ¶ 1(b).

117 One would have to calculate the revenues generated from non-business income under the three-factor formula versus the MTC plan described in this section. This would require information on the relative number of commercial domiciles and non-business, income-generating properties, patents, and copyrights within the state.
ing to calculate the non-business income allocation separately. It is included as a part of the three-factor formula calculation. One negative aspect though, is that once again, Michigan has deviated from the MTC, the purpose of which was to create a uniform allocation system.

In summary then, it has been shown that although Michigan has nominally adopted the MTC, it has deviated from it in the areas of “business activities,” certain special industries, small taxpayers, and non-business income.

C. The Determination of “Taxable Income”

There are approximately twenty adjustments to federal taxable income to arrive at SBTA taxable income. Many are of a minor nature and need not be discussed; however, some significantly differ from what might be expected and merit special attention.

Federal gross income excludes interest received from securities issued by state governments and their subdivisions. In order to subject that income to taxation, Michigan adds the interest so excluded back into income for SBTA purposes. However, only the income from securities of states other than Michigan is added back. Apparently to protect and promote investment in Michigan securities, the income from them is not taxed.

Another adjustment made to federal taxable income for SBTA purposes is that of disallowing the federal net operating loss deduction.

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118 The Multistate Tax Commission might consider whether the benefits of the allocation used by this section, as opposed to the three-factor method, outweigh the “cost” of the additional computations. The cost seems particularly high in view of the fact that it involves non-business income, by definition, a relatively small part of total income. It would seem that some distortion of economic reality is acceptable for such a small percentage of total income.


121 MICH. COMP. LAWS ANN. § 208.9(2) (Supp. 1976). Certain expenses related to this type of income are disallowed at the federal level under Int. Rev. Code of 1954, § 265. They are not deductible because, since the income they generate is not taxed, the expenses incurred in generating it should not be deductible. To the extent these expenses are excluded at the federal level, they may be deducted for Michigan purposes. Mich. Comp. Laws Ann. § 208.9(2) (Supp. 1976). This is appropriate since, if the income is to be taxed, the expenses incurred in generating it should be deductible. Apparently, the expenses can be deducted even if they exceed the income generated. This is also proper since it is an investment loss like any other.

122 “State” is defined to include political subdivisions thereof. Mich. Comp. Laws Ann. § 208.7(2) (Supp. 1976).

123 Only that interest incidental to business income is added back. The fact that a partner holds bonds which are federally tax-exempt does not necessarily imply that he should add back the income for SBTA purposes. Only if the income generated by the bonds is “business income” would he add it back. If the income is generated from the investment of his personal funds, it would not be business income. See id. § 208.3(2), (3); P-H State and Local Taxes, Special Michigan Report ¶ 155 (1975).


Instead, the SBTA substitutes its own version of the operating loss deduction. After the allocation of all multistate income\(^\text{125}\) and certain other items,\(^\text{126}\) any unused business loss from prior years is deducted\(^\text{127}\) until the present year's taxable income is reduced to zero. Remaining losses from prior years and any additional losses generated in the current year\(^\text{128}\) may then be carried forward to offset up to ten future years' taxable income. The losses may not be carried back to prior years.\(^\text{129}\) This differs from the federal approach which allows the loss to be carried back three years and forward five.\(^\text{130}\) While the Michigan approach may superficially appear more generous, allowing a total of ten years for which the loss can be carried, as opposed to the federal tax's eight (back three, forward five), the lack of a carryback provision is significant.

Carryback provisions are highly beneficial in a loss year because that loss can be carried back to offset prior profitable years' income. This reduces the tax liability for those earlier years and results in an immediate refund of the tax paid in those years.\(^\text{131}\) The refund comes at the time when the business needs it most — early in the year following the loss year. On the other hand, the only solace Michigan provides for the business taxpayer that has suffered a loss year is that future years' taxes will be reduced. While this is probably sufficient for taxpayers suffering losses for one or two years,\(^\text{132}\) for taxpayers with losses over a three to five year period, an immediate refund would be more beneficial than a possible tax reduction five years hence,\(^\text{133}\) when the business becomes profitable again. In fact, without the refund, there is an increased chance the company may not survive long enough to reap the benefits of the loss carryforward.\(^\text{134}\)

\(^{125}\) Allocation of multistate income is discussed in notes 44-56 supra and accompanying text. While that allocation also affects Michigan taxable income, it will be discussed separately.


\(^{127}\) Id. § 208.23(e). Unused losses from the now repealed corporation income tax may also be deducted until they expire on December 31, 1980. Id. § 208.23(f).

\(^{128}\) The loss is not deductible in the loss year but may only be carried forward to offset future years' income. Id. § 208.23(e).

\(^{129}\) Id.


\(^{131}\) Losses still unused after the reduction of all three prior years' income to zero, are then carried forward. If losses were incurred in all three prior years, only carryforward is available. The carryback/carryforward is applied in chronological order, beginning with earliest eligible year. Id. § 172(b)(2).

\(^{132}\) For instance, if the taxpayer suffers a loss in one year, but recovers in the next, the benefit of the carryforward will begin to be realized when the next SBTA estimated tax payment is made. The payment will be reduced by the proportionate amount of the carryforward. Of course, if there were only losses in the prior years, there would be no profitable years to which the loss could be carried, thus only carryforward would be available.

\(^{133}\) Unlike the taxpayers described in note 132 supra, those with losses over a longer period are making no estimated tax payments anyway, because they anticipate no tax liability for the coming year. Not until they return to a profitable situation will they be able to utilize the carryforward.

\(^{134}\) If the loss has not been fully utilized, the loss carryforward expires at the end of the
Doubtless, part of the reason Michigan has avoided operating loss carrybacks is to keep the tax as simple as possible. Nevertheless, even a very basic carryback provision would provide a much-needed injection of funds to the taxpayer that has suffered three to five years of losses.

The most unusual adjustments made in computing SBTA taxable income are those pertaining to wages and the cost of capital assets. The objective of the adjustments apparently is to tax labor-intensive industries on a par with capital-intensive industries and to give the tax some of the characteristics of a value-added tax.

First, all deductions for "compensation" are added back to federal taxable income to determine SBTA income. In other words, compensation is not a deductible expense for SBTA purposes. Compensation is defined to include payments for unemployment insurance, social security, pension and profit sharing plans, and other indirect forms of compensation, as well as salaries and wages. This effectively denies any deduction for any type of compensation, regardless of its form.

The denial of a deduction for compensation expenses is highly unusual in the field of income taxation. It denies recognition to one of the most significant expenses of operating a business. The ramifications are difficult to estimate, but it seems clear that this innovation will have some inhibitive effect on labor-intensive industries. While certain provisions mitigate the effects of the adjustment, it appears they offer relief only to the most labor-intensive industries. Those more closely

close the tenth year. In that case, or if the taxpayer goes out of business, the carryforward benefit has been lost forever.

Loss carrybacks are especially complicated because they require a recomputation of a prior year's taxes as long as three years after the original computation was made. Changes in the law since the date of the original computation present one problem. Carryforwards, on the other hand, are usually simpler since they are taken as a reduction of income for the year in which they are being utilized and in which the return is being computed. Since businesses can, to some extent, control losses, the lack of a carryback reduces the ability to take a loss in order to generate a refund. Ohio does not allow a loss carryback either. See note 193 infra and accompanying text.

Another reason why states may choose not to adopt the carryback provision of the federal income tax is based on the fact that they deal with a narrower tax base than the federal government. If a state's economy is heavily dependent upon one industry, in any year when business is bad for that industry the state treasury would be "squeezed" from two directions. It would be receiving fewer revenues, and in addition, would be forced to pay out refunds to businesses that had suffered a net loss.

P-H STATE AND LOCAL TAXES, SPECIAL MICHIGAN REPORT ¶ 200 (1975).

Id. ¶ 100.

MICH. COMP. LAWS ANN. § 208.9(5) (Supp. 1976). The lack of a deduction for compensation does help to eliminate the frequent abuse by close corporations taking all of the profits of the corporation out as "salary" rather than paying the double tax on dividends.

Id. ¶ 208.4(3).

The concept of income taxation is usually based on a tax on the net income of the business as computed for financial accounting purposes with minor adjustments. See INT. REV. CODE OF 1954, § 162(a)(1); note 187 infra and accompanying text; P-H STATE AND LOCAL TAXES, ALL STATES UNIT ¶ 91,307 (1962).

MICH. COMP. LAWS ANN. §§ 208.31(2), (5) (Supp. 1976). In addition, id. §§ 208.31(6), (7) will give some relief through 1977.
balanced between the labor and capital factors of production will not be helped at all by these provisions.142

While this denial of a deduction for compensation expenses is unusual, the adjustment for capital asset expenditures is even more novel. Under the SBTA, the cost of tangible, depreciable assets is fully deductible in the year of purchase, and the gross proceeds from the sale of assets are added back to income in the year of sale.143 In other words, there is no depreciation taken under the SBTA for most assets; rather, a full cost deduction is allowed in the year of purchase.

Rather than allowing such a full cost deduction in the year of purchase, most income taxes prorate the cost of the asset over its useful life.144 This is accomplished by deducting (deprecating) a portion of the cost each year until the total cost, less salvage value, has been deducted. Thus, the total cost of the asset is recognized through a series of annual charges rather than by a full deduction in the year of purchase. Under both systems the total amount deducted is the same, only the timing is different. Theoretically, depreciation better matches the cost of the asset with the economic services generated by it.145 The allowance of a full cost deduction denies the economic reality of capital asset utilization. It assumes the full economic service value of the asset is expended in one year — an assumption that is false for most assets.

The mechanics of the capital asset deduction are complex, but seem internally consistent.146 They do, however, reveal a more preferential treatment for Michigan real estate than for realty in other states. The SBTA provides that for all personalty, and for Michigan realty, depreciation must be added back to taxable income, thus denying a deduction for any depreciation taken for federal tax purposes. A full cost deduction

142 If the tax base exceeds 50% of Michigan gross receipts (either actual or allocated), such excess can be used to reduce the tax base; or, if compensation exceeds 65% of the tax base, such excess up to 35% of the tax base can be used to reduce that base. Id. §§ 208.31(2), (5). The effect of these provisions is: (1) to limit the overall tax base, regardless of the labor adjustment, to 50% of gross receipts, thus ameliorating the tendency of the SBTA toward a gross receipts tax in certain situations; and (2) to reduce the impact of the labor cost adjustment when labor exceeds 65% of the tax base. Since the 65% minimum must be met before relief is available, only those industries and businesses which are highly labor-intensive would be helped by the saving provision. In addition, the taxpayer can elect to use only one of these provisions.

143 Id. §§ 208.23(a)-(d).

144 See, e.g., INT. REV. CODE OF 1954, § 167.

145 An excellent introduction to depreciation and the policies behind it is found in J. FREELAND & R. STEPHENS, CASES AND MATERIALS ON FUNDAMENTALS OF FEDERAL INCOME TAXATION 689-700 (1972).

146 The related sections are Mich. Comp. Laws Ann. §§ 208.9(4)(b), (4)(c), (6), (8), 208.23(a)-(d) (Supp. 1976). The inclusion of gross proceeds in the year of sale is consistent as it reflects the true cost of the asset (original price paid less proceeds of sale). In traditional tax terms, the full deduction in the year of acquisition reduces the basis in the asset to zero. Any proceeds at sale will be in excess of basis and will be ordinary income.

These sections eliminate for Michigan purposes all depreciation, capital gains, and ordinary income from the sale and exchange of capital assets, that had been recognized at the federal level. They appear to have negativized the income aspects of asset ownership that exist at the federal level (including INT. REV. CODE OF 1954, §§ 1245, 1250), allowing Michigan to apply its own methods.
is then taken for the cost of personalty and Michigan realty, less the proceeds from any sales of such items during the year.\textsuperscript{147} Real estate located outside Michigan is not entitled to the full cost deduction;\textsuperscript{148} however, a portion of the depreciation taken on such realty for federal tax purposes is allowed to flow through as a deduction for Michigan purposes. Unfortunately, the statute and the Single Business Tax Division of the Michigan Department of Treasury do not seem to be in agreement about the percentage of depreciation that is to be allowed to flow through. The analysis of the statute is complex, but it is possible that it contains a drafting mistake. The Single Business Tax Division has already issued conflicting interpretations of it.\textsuperscript{149} Conflicts notwithstanding, it seems clear that the intent was to allow a full cost deduction for Michigan realty, but to allow only the depreciation of non-Michigan realty and then to allow only a portion of the depreciation taken at the federal level.

What, then, is the purpose of allowing a full cost deduction for capital assets? One purpose is to favor capital-intensive industries. They receive an immediate deduction for capital expenditures rather than a series of small deductions over a period of years.\textsuperscript{150} The more assets such an industry purchases, the lower its taxable income. Theoretically, this motivates them to replace assets more quickly and such purchases

\begin{itemize}
\item[147] MICH. COMP. LAWS ANN. §§ 208.23(a)-(d) (Supp. 1976).
\item[148] Id. § 208.9(4)(c) read in conjunction with Id. § 208.23(a)-(d).
\item[149] Id. § 208.9(4) reads in part:
\begin{quote}
(4) Add, to the extent deducted in arriving at federal taxable income:
\begin{quote}
(c) Any deduction for depreciation ... pursuant to [section 208.23] ...
and for the 1976 tax year, 72%, for the 1977 tax year, 50%, and for 1978 and subsequent tax years 40% of any deduction for other depreciation. ...
\end{quote}
\end{quote}
\end{itemize}

Section 208.23 referred to above covers the deduction for all personalty and all Michigan realty. Thus, only non-Michigan realty is covered by the percentages in the last two sentences quoted above. The section requires that 72% of depreciation on non-Michigan realty be \textit{added back} to income. When 72% is added back, 28% remains as a deduction for 1976. Likewise, 50% for 1977 and 50% for 1978 and thereafter.

When it first addressed the question, the Michigan Department of Treasury asserted that the amount of depreciation allowed was the amount quoted in the statute (72%, 50%, 40%). \textit{MICHIGAN DEPT OF TREASURY, SINGLE BUSINESS TAX QUESTIONS AND ANSWERS} vol. 1, Question 8 at 2 (Sept. 15, 1975) on file in the offices of Cleveland State Law Review (reproduced in 1 CCH Mich. Tax Rep. ¶ 19-001 (1975)). This interpretation is contrary to the analysis above which concludes that the amount of depreciation allowed is the reciprocal of the percentage quoted in the statute. Three months later, the Department agreed with the above (reciprocal) interpretation. \textit{See Single Business Tax Division, Michigan Dep't of Treasury, the New Single Business Tax 2, 3} (Dec. 5, 1975), on file in the offices of Cleveland State Law Review.

It would seem to make more sense for the legislature to phase out depreciation on non-Michigan realty (72-50-40%), rather than to adopt the reciprocal interpretation that is suggested (28-50-60%). This would allow taxpayers time to adjust to the change, rather than making it more difficult on them in the early years and reducing the burden in later years. Thus, there may be a drafting mistake in \textit{MICH. COMP. LAWS ANN.} § 208.9(4)(c) (Supp. 1976). At the very least, it has succeeded in confusing the Single Business Tax Division.

\textsuperscript{150} The benefit of an immediate deduction rather than the same total deduction spread over a series of years is determined by a concept known as the present value of money. Basically, the theory is that it is better to have access to the money sooner. This enables the holder to invest and earn a return on the money for that much longer.
should stimulate the state's economy. Certainly, heavy industry should find this provision appealing.\[151\]

The elimination of depreciation accounting should simplify the tax system. Allowing a full cost deduction avoids the many complexities of depreciation and the problems it leads to.\[152\] Unfortunately, the taxpayer has already dealt with those problems at the federal level of taxation. Thus, it would be far easier for Michigan to allow the depreciation computed for federal purposes to flow through to Michigan, rather than attempt to negate the federal computation and then add Michigan's own, different method for the recognition of capital asset expenditures. This further complicates an already troublesome area.

The add-back of wages and the full deduction of asset costs are unusual provisions.\[153\] The SBTA also denies a deduction for interest expenses.\[154\] Operating together, the economic impact of these adjustments is difficult to evaluate. The wage and interest add-backs are inhibitive in that they do not allow a deduction for a normal, significant cost of operating the business, while the full cost asset deduction promotes expenditures for those items. Most companies will be subject to all of these provisions, will enjoy the benefit of the asset deduction, and pay the penalty of the labor and interest add-backs. This makes the economic impact of the SBTA that much more difficult to predict. Probably the best generalization that can be made is that businesses which have proportionately high labor and interest expenses will be taxed more heavily, while those with a significant portion of their property in depreciable, capital assets will be taxed very lightly.

D. "Persons" Taxed by the SBTA

Apparently attracted by the prospect of additional revenue, the Michigan legislature structured the SBTA so that the tax would reach the business activities of every type of business, regardless of its organizational structure. Corporations, partnerships, joint ventures, associations, estates, and trusts are defined as "persons" subject to the tax.\[155\] The unusual aspect of this definition is the inclusion of unincorporated enti-

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151 The deduction is especially appealing to expanding capital-intensive companies. They are purchasing considerably more equipment than they are selling and thus getting large, full-cost deductions with little add-back for the proceeds of the sales. Conversely, companies in a downturn, are selling more assets than they are buying and thus may be in a position in which the proceeds of sales exceed the full cost deductions for purchases. In short, the provision helps companies already expanding and penalizes those experiencing a downturn, perhaps an anomalous position.

152 An indication of one aspect of the problems of depreciation accounting is Wisniewski, Parker & Jenkins, Another Look at Depreciation Reform, 4 Tax Adviser 452, 552 (1973).


155 Id. §§ 208.6(1), .31.
ties. Prior to the enactment of the SBTA only three other states imposed income taxes on such entities. 156

As discussed above, one of the problems in structuring a tax on unincorporated businesses is the fact that when the tax is imposed at the entity level, the result is a decline in the revenues generated by the personal income tax. If, however, the partnership cannot deduct the SBTA tax paid by the partnership from the individual partner's share of the earnings, this problem is avoided. The partnership pays an SBTA tax on its total income and the partners pay their personal income tax without regard for the new tax imposed on the entity. Expanding the example from above, if a new 10% tax is imposed on a partnership with a net income of $100,000, it generates revenue of $10,000 (10% of $100,000). The $10,000 tax is paid by the entity and cannot be deducted from the individual partners' share of the profits. So their "earnings" for the year are still $100,000 which is then subjected to the personal income tax. Since the partnership cannot deduct the SBTA tax from the individual partners' shares, the partnership pays the full SBTA tax and the partners the full personal income tax.

New revenue has been generated by the new tax on the unincorporated entity without a reduction in revenues derived from personal income tax. This type of tax will always result in an increase in net revenues, and it is the method that has been adopted by the SBTA. 158

While the method described is an effective revenue-raising device, it is somewhat harsh. In the example, the partners must pay personal income tax on $100,000 even though the partnership generated only $90,000 ($100,000 less the $10,000 tax on the entity). In order to mitigate this effect, the Michigan personal income tax has been modified to allow credits against the personal income tax liability for the SBTA tax paid by the entity. The credits range from 20% to 10% decreasing as business income increases. It is available to individuals, partners, and Subchapter S shareholders, but apparently not to corporate share-


156 See note 66 supra.

157 See text accompanying notes 71-72 supra.

158 Apparently any SBTA tax paid by the partnership is not deductible in computing the individual partner's share of income although for purposes of the personal income tax, the statute is not clear. Taxable income, for the personal income tax, is defined as federal adjusted gross income. Mich. Comp. Laws Ann. § 206.30(1) (Supp. 1976). Adjusted gross income is gross income less trade and business expenses of those who are not employees. Int. Rev. Code of 1954, § 62(1). SBTA taxes paid would qualify as trade or business expenses under id. § 162, and partners would not be considered employees. (Employees are defined to be "employees" for federal tax purposes. Mich. Comp. Laws Ann. § 206.8(3) (Supp. 1976). In Int. Rev. Code of 1954, § 3401(c), the definition of employees, has been construed not to include partners. Rev. Rul. 69-184, 1969-1 Cum. Bull. 256). Therefore, federal adjusted gross income, for purposes of the Michigan personal income tax, would be net of any SBTA tax paid by the partnership. However, the personal tax requires the add-back of any tax paid by the business levied on or measured by income. Mich. Comp. Laws Ann. § 208.30(1)(b) (Supp. 1976). While the SBTA is defined not to be a tax on net income, id. § 208.31(4), it is a tax measured by net income and would have to be added back to arrive at income for purposes of the Michigan personal income tax. If it is added back to federal adjusted gross income, it is not deductible for purposes of the Michigan personal income tax. Thus, the tax is levied without regard for any SBTA tax paid by the partnership.
holders. The amount of the credit cannot exceed the personal tax liability and is not available if the entity has elected the 50% gross receipts limitation under SBTA section 208.31(2).159

Thus, Michigan has levied its business tax on unincorporated and incorporated businesses alike. It is one of a minority of states to do so and the Michigan experience will undoubtedly influence other state legislatures. Michigan's experience will probably help to determine whether an entity tax on the income of unincorporated businesses continues to exist in only a minority of states or whether it becomes a commonplace revenue-raising device.

III. THE OHIO INCOME/FRANCHISE TAX

A. The Type of Tax Adopted

Ohio presently uses a hybrid method for the taxation of businesses. The tax is the higher of (1) a franchise tax imposed on the corporation's capital, surplus, and net worth,160 (2) an income tax,161 or (3) $50.162 In other words, the tax has the income, franchise, and minimum payment features discussed above.163

Although it is not clear, perhaps the reason for the use of the hybrid method is that the Ohio legislature sought to have the best of both worlds. There had always been a franchise tax,164 and when an income tax was being considered the legislature decided to keep the franchise tax along with the new income tax. If the income tax did not provide the revenue that had been estimated, the franchise tax would be there to provide the revenue it always had. If the income tax operated as planned, so much the better. The legislature was probably wary of abandoning the assured revenue of the franchise tax in favor of the then untested income tax. Furthermore, 35 states still impose some combination of the two taxes,165 so the idea was not revolutionary. Five years later, both taxes are still in effect.

B. Ohio's Multistate Income Allocation

Although Ohio did not adopt the Uniform Act, it is a member of the MTC.166 Its allocation statute probably follows the MTC more closely


160 Ohio Rev. Code Ann. § 5733.06(C) (Page 1973), used in conjunction with id. § 5733.05(A) (Page Supp. 1976).

161 Id. §§ 5733.06(A), (B) (Page 1973), used in conjunction with id. § 5733.05(B) (Page Supp. 1976).

162 Id. § 5733.06 (Page 1973).

163 See notes 6-37 supra and accompanying text.

164 A brief history of the Ohio franchise/income tax is in P-H State and Local Taxes, Ohio Unit ¶ 10,205 (1975), which indicates that Ohio's first franchise tax was enacted in 1904.

165 See note 29 supra and accompanying text.

166 See P-H State and Local Taxes, All States Unit ¶ 5151 (1975); UDITPA, 7 Uniform Laws Ann. 258 (Supp. 1976).
than does Michigan'.\(^{167}\) The one major change Ohio made in the MTC approach was in the special treatment of non-business income. Unlike Michigan, Ohio adopted the MTC treatment of non-business income with its special methods for allocating rental, royalty, capital gain, interest, and dividend income. The difference is that Ohio allocates all such income by the special methods, regardless of its business or non-business nature.\(^{168}\) The effect of using the special methods for business income as well, is difficult to evaluate for the same reasons outlined in the Michigan discussion\(^{169}\) and also poses additional problems.\(^{170}\)

It seems odd that Ohio would adopt the non-business income formula almost verbatim,\(^{171}\) but fail to limit it to non-business income, as the MTC does. At least one looseleaf service has stated that the provisions for rental, royalty, capital gain, interest, and dividend income apply only to non-business income. The service stated that the special provisions apply to non-business income and that the three-factor formula allocates business income.\(^{172}\) The editors of the service, however, appear to have been confused by the Ohio treatment since they referred to all rental, royalty, dividend, and related income as non-business income. They failed, as the statute does, to make the distinction between rental, royalty, and dividend income that is business income and that which is non-business income. They referred to all rental, royalty, dividend, and related income as non-business income when, under the Uniform Act which they cite, such income could also be business income. The other looseleaf service\(^{173}\) and the Ohio Tax Commissioner,\(^{174}\) consistent with the statute,\(^{175}\) do not make the distinction and allocate all rents, royalties,


\(^{169}\) See note 117 supra and accompanying text.

\(^{170}\) By not making the distinction, the statute causes problems for those businesses that have rental, royalty, etc. income in the regular course of business. For them, those items should be allocated as regular income (three-factor formula) and they are so allocated under the MTC and the SBTA. Under those methods, such income is allocated specially only if it represents non-business income. Since Ohio does not make the distinction, however, the income would be allocated specially regardless of its business/non-business nature.

\(^{171}\) The most substantial deviation is in the treatment of dividends and interest. Interest, because it is not specifically treated and is allocated under Ohio’s three-factor formula by Ohio Rev. Code Ann. § 5733.05(B) (Page 1973), and dividends which are allocated using a simplified property factor, id. § 5733.051(A)(6).

Under the MTC method, both of these items would be allocated to the state of the business’ commercial domicile. P-H State and Local Taxes, All States Unit ¶ 6321 (1975). Evaluating the effect of these changes is difficult, though it would appear more substantial in the case of Ohio, since it involves all interest and dividend income rather than only the non-business portion, as in Michigan.


\(^{173}\) See P-H State and Local Taxes, Ohio Unit ¶ 10,347 (1974).

\(^{174}\) CCH State Tax Rep., Ohio Unit ¶ 1189 (1975) (instructions for the preparation of Schedule C to the Ohio franchise tax return).

\(^{175}\) There is no mention of these terms in the provision for allocation of rents, royalties,
ties, and related income specially. By following the MTC word for word except for the key business/non-business income distinction, the Ohio legislature has deviated from the MTC and caused some confusion as to why the change was made and how the statute should be applied. A change in the language to comply with the MTC would resolve this problem.

Similar problems exist in the Ohio three-factor formula itself. Ohio's formula substantially follows the MTC method. The property factor differs in that it excludes Ohio pollution control facilities but this does not appear to be a major deviation. Ohio's definition of "sales," as used in the sales factor, varies slightly from the MTC definition and might also be dismissed as of little significance, except that closer analysis reveals a substantial departure from the intent of the MTC. Further, it appears that it may have been a result unintended by the legislature.

The Ohio sales factor is defined as:

\[
a \text{fraction the numerator of which is the value of business done, measured by sales of tangible personal property in this state . . . and the denominator of which is the total value of its business done, measured by sales of tangible personal property by the corporation everywhere during such year.}
\]

This definition on its face appears to include in the sales factor only sales of tangible personal property with no mention of sales of intangibles. It would appear, therefore, that the value of business done is to be measured only by sales of tangible personal property. While it could be argued that the emphasis should be on value of business done, and that sales of tangible personality is only illustrative, the statute, standing alone, appears to lend itself better to the first interpretation since it so clearly specifies sales of tangible personality.

The problem with this literal reading arises when the quoted section is read in conjunction with the definition of "tangible personal property," which states in part: "[t]o the extent that the value of business done in this state is measured by sales of tangible personal property . . . " This implies that the value of business done may be measured by something other than sales of tangible personality, despite the conclusions reached above. Sales of other than tangible personality (intangibles) are also defined in the same section, but there is no reference to "value of business done."

Thus, there is nothing in the statute which links sales of intangibles to the sales factor or to the "value of business done" etc., see Ohio Rev. Code Ann. § 5733.051 (Page 1973), or in the section which defines terms generally, id. § 5733.04 (Page Supp. 1976).

176 Compare P-H State and Local Taxes, All States Unit ¶¶ 6323, 6332 (1975) with Ohio Rev. Code Ann. § 5733.05(B) (Page Supp. 1976).
180 Id.
181 Id.
and thus to the sales factor definition. This results in confusion about whether the Ohio sales factor includes anything other than sales of tangible personalty. By following the language of the MTC almost word for word,¹⁸² and yet specifically deviating from the unambiguous MTC language¹⁸³ in order to discuss sales of tangible personalty, the Ohio legislature may well have excluded sales of intangibles from the sales factor. At the very least, such a deviation creates an ambiguity in the statute.

Despite the fact that the legislature revised this section in 1973, it failed to resolve this problem leaving the language unchanged.¹⁸⁴ Perhaps, though, it did not feel a clarification was necessary since the sales factor is now treated as including only sales of tangible personalty, consistent with the strict statutory construction.¹⁸⁵ Nevertheless, a small change in the language would bring the statute into compliance with the MTC and resolve any questions that may remain.

C. The Determination of "Taxable Income"

Like Michigan, Ohio begins its computation of income with federal taxable income.¹⁸⁶ The statute then lists nine adjustments to arrive at income for Ohio purposes.¹⁸⁷ The adjustments cover dividends received, capital losses, certain methods of accounting, and taxes on intangible property.¹⁸⁸ Such adjustments are typical of those made by most states.¹⁸⁹ One Ohio adjustment that merits attention is the net operating loss deduction. As originally enacted, the deduction was rather limited in scope,¹⁹⁰ but allowed a carryforward until the loss was fully

¹⁸² See note 167 supra.

¹⁸³ "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this State . . . ." P-H State and Local Taxes, All States Unit ¶ 6329 (1968) (emphasis added). This certainly includes sales of both tangible and intangible personalty. Those items are defined separately, id. ¶¶ 6330, 6331, as they are in Ohio.

¹⁸⁴ The former text is found in Ohio Rev. Code Ann. § 5733.05(C) (Page 1973), the revisions in id. § 5733.05(B)(2)(c) (Page Supp. 1976).

¹⁸⁵ See P-H State and Local Taxes, Ohio Unit ¶ 10,353 (1976) and instructions for 1975 tax returns contained in id. ¶ 15,825.


¹⁸⁷ Id. The figure is apportioned among the states under id. §§ 5733.05(B)(2), 5733.051 (Page 1973).

¹⁸⁸ Id. § 5733.04(I) (Page Supp. 1976).

¹⁸⁹ See, e.g., Md. Ann. Code art. 81, §§ 280A(b), (c) (Supp. 1975); N.Y. Tax Law §§ 612(b), (c) (McKinney 1975).

¹⁹⁰ Ohio Rev. Code Ann. § 5733.04(I)(1) (Page 1973). The section precluded the use of the deduction until the corporation paid its tax on the net income base. If the company
utilized, without the usual time period limitations.\textsuperscript{191} Two years later, the Ohio legislature changed the provision to allow its use in a broader range of circumstances and to limit the carryforward to five years.\textsuperscript{192} No carryback of the loss is permitted.\textsuperscript{193}

The second unusual thing about Ohio's adjustments to federal taxable income is a provision noticeable by its absence: a requirement that any Ohio income/franchise tax deducted in computing federal taxable income be added back for purposes of computing the Ohio income/franchise tax.\textsuperscript{194} The problem is in the sequence of the computation. In the computation of its federal taxable income, a company is rightfully entitled to deduct its Ohio tax as an ordinary and necessary expense of the business.\textsuperscript{195} In order to determine its Ohio tax, however, the company must have already computed its federal taxable income (the Ohio tax computation begins with federal taxable income). The company cannot compute its federal tax until it computes its Ohio tax; it cannot compute its Ohio tax until it computes its federal tax. The problem is illustrated in detail in the note below,\textsuperscript{196} but the consequences of this

\begin{enumerate}
\item[191] Id.
\item[192] Id. (Page Supp. 1976).
\item[193] Id.
\item[195] INT. REV. CODE OF 1954, § 162 and related regulations.
\item[196] Assume a taxpayer with $100,000 of pre-tax income and an Ohio income tax rate of 10%. The federal tax liability would be computed thus:
\begin{align*}
$100,000 \text{ Pre-tax income} & - 10,000 \text{ Less: Ohio income/franchise tax at 10\%} \\
$90,000 \text{ Federal taxable income}
\end{align*}
Now compute the Ohio tax (assuming no other Ohio adjustments):
\begin{align*}
$90,000 \text{ Federal taxable income (computed above)} & - 9,000 \text{ Ohio tax at 10\%} \\
$81,000 \text{ Ohio tax liability}
\end{align*}

The company has two different Ohio tax liabilities: $10,000 for federal tax purposes and $9,000 for Ohio purposes. Clearly both cannot be correct and, in fact, neither is. By means of a simultaneous equation the taxpayer should have computed its Ohio tax liability to be $9,091. The formula that yields this liability is $X=10($100,000-X)$ when $X=$ Ohio tax liability. The proof of the answer is:
\begin{align*}
100,000 \text{ Pre-tax income} & - 9,091 \text{ Less: Ohio tax} \\
89,909 \text{ Federal taxable income}
\end{align*}
Now compute the Ohio tax:
\begin{align*}
89,909 \text{ Federal taxable income (computed above)} & - 9,091 \text{ Ohio tax at 10\%} \\
80,818 \text{ Ohio tax liability}
\end{align*}

The company has the same liability for state and federal purposes. Its Ohio tax deduction for federal tax purposes equals its Ohio tax liability, a situation which did not exist in the first example.

Assuming that $9,091 is the correct Ohio tax liability, note that in the first example both federal and Ohio tax liabilities were understated. In the first example the federal taxable income was $90,000; in the simultaneous equation it was $90,909. Thus, federal taxable income was understated by $909. The Ohio tax in the simultaneous equation was $9,091, but only $9,000 in the first example. Thus, Ohio tax revenue was understated by $91.
omission should be noted. First, in order to properly compute its federal and Ohio taxes, a company must use a simultaneous equation; second, the omission reduces both Ohio and federal taxes from what they would be if there were an add-back of the Ohio tax. It is difficult to believe the omission was intended because of the complexities it leads to and the revenues that are lost. Therefore, it appears to be an inadvertent error that should be rectified.

D. "Persons" Subject to Taxation

The entities reached by Ohio taxes are the traditional ones taxed by the majority of the states. The income of trusts is allocated to the beneficiaries and then subject to the personal income tax. Ohio estates are also subject to the personal income tax, and the franchise tax is levied solely on corporations. Thus, unincorporated entities escape Ohio taxation at the entity level. There is little innovative in subjecting only these "persons" to taxation.

IV. COMPARATIVE ANALYSIS OF THE SBTA AND THE OHIO TAX

A. The Type of Tax

As has been noted, Michigan adopted the income-based SBTA as the primary tax on business activity within the state, while Ohio retains the hybrid income/franchise tax. As previously discussed, the faults of the franchise tax are: It strongly emphasizes the importance of the financial structure of the corporation, may not share in the long-term growth of the company, can preclude the taxation of unincorporated businesses, and often has little regard for the ability to pay doctrine.

The advantages of the income tax were also discussed, and it was concluded that because the tax is based upon ability to pay it is probably the most equitable for the taxpayer. While one may dispute the asserted advantages of the income tax and differ with Michigan's reliance on it, it seems clear that Ohio's continued use of both income and franchise taxes is burdensome and unnecessary. The retention of both taxes is unnecessary because, after five years, the Ohio legislature should be

If the Ohio tax were simply added back, all of the above problems would be eliminated:

$100,000 Pre-tax income
10,000 Less: Ohio tax at 10%
$90,000 Federal taxable income
10,000 Add back Ohio tax deductions
$100,000 Ohio taxable income
$10,000 Ohio tax at 10%

Under this method the Ohio tax is the same for federal and state purposes and there is no need for the use of a simultaneous equation.


199 Id. § 5747.01(S).
191 Id. § 5733.06 (Page 1973).
200 See notes 6-37 supra and accompanying text.
able to estimate the revenue from the income tax operating alone.\footnote{It would be interesting to learn how much revenue is generated by the franchise tax computation alone. Unfortunately, Ohio's published data only show the total income/franchise tax revenue. \textit{See, e.g., 1973 Ohio State Auditor Annual Rep. 9.}} With appropriate rate changes, present revenue could be maintained by relying on the income tax alone. The use of both taxes is burdensome because the taxpayer must compute its liability under two separate and very different kinds of taxes and then pay only one of them — the higher one. Thus, in all fairness to the taxpayers, it would seem that Ohio should rely on one tax, the income tax.

\section*{B. Multistate Income Allocation}

Both Michigan and Ohio have adopted the fundamentals of the MTC. The problem with the statutes enacted by the two states is that both of them make changes in the MTC language, an approach that can create a significant impact upon individual business taxpayers. Michigan made changes in the sales factor, in allocation for special industries, and in the treatment of non-business income. Ohio's allocation statute follows the MTC more closely. The only notable deviation is that the MTC's special treatment of non-business income items is not limited by Ohio to non-business income, but extends to all income. It appears that the Ohio changes have a less significant impact on taxpayers than do Michigan's, but this is principally because the Ohio changes are confined to one portion of the MTC. Without detailed statistics on business income within each state, it is difficult to evaluate the effect of the changes made by the two states. It is clear, however, that any deviation from the MTC thwarts the basic purpose of a uniform allocation system, thus defeating the ultimate goal of the MTC — reasonable and equal treatment of individual taxpayers in all states.

\section*{C. The Determination of "Taxable Income"}

The nature of the adjustments to federal taxable income to arrive at Michigan taxable income have already been discussed.\footnote{E.g., adjustments to dividends received, certain taxes paid, royalties, unusual financial accounting methods, and special projects within the state which the state wishes to promote.} It was noted that a full cost deduction is allowed in the year of purchase, no depreciation is taken on those assets, and no deduction of labor and interest expenses is permitted.

Perhaps the most significant aspect of these adjustments is that they vary from the usual notions about the definition of taxable income. While all states have their own definition of income, most adopt the federal definition and make only minor adjustments. The items adjusted usually represent a relatively small percentage of an enterprise's total income.\footnote{\textit{E.g.,} see notes 119-54 supra and accompanying text.} Few such adjustments make changes in the deduction of the major expenses of the business — things like labor, interest, and capital asset costs. Because of these major adjustments, SBTA taxable
income may vary widely from income for financial accounting, federal tax, or other state's tax purposes. In fact, the SBTA's definition is so different, that the tax approaches the outer limits of what can be regarded as an income tax. It has taken on many of the characteristics of a value-added tax. As a result, many of the attributes and benefits derived from the use of an income tax may not apply to the SBTA. Not the least of these differences may be the possible infringement of the ability to pay maxim. Disallowance of a deduction for the cost of labor and for interest appears to violate the maxim by imposing a tax irrespective of significant, legitimate costs of the business. Allowing a full deduction for the cost of capital assets will encourage long-term financing of such assets because a full deduction can be achieved with minimal cash paid and little change in ability to pay. The effect of these adjustments may well result in the characterization of the SBTA as not truly an income tax, but rather as a hybrid of income and value-added taxes.

It is doubtful that this definition of taxable income will become a model for other states. The value-added tax has not been favored in this country largely because it substantially deviates from the taxes presently imposed. The complexity of the income tax is frequently criticized. Mixing the income tax with the elements of a value-added tax when the benefits are, as yet, uncertain would seem to be a risk few legislatures would be willing to undertake. Thus, unless the benefits of the Michigan income/value-added tax are demonstrated to be clearly superior to those of any other tax, that form of taxation will likely remain indigenous to Michigan.

The Ohio definition of taxable income is remarkably typical of that of other states. The federal definition has been adopted by Ohio with only minor adjustments. One of the adjustments made by Ohio is worth reviewing, that is, the rather short net operating loss carryforward limita-

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204 The denial of a deduction for labor and interest effectively means that the value of those items is taxed. The taxation of such items as measures of the value added to the final product, is common to value-added taxes. See generally R. Wagner, R. Freeman, C. McClure, N. Tune & E. Schiff, PERSPECTIVES ON TAX REFORM — DEATH TAXES, TAX LOOPHOLES AND THE VALUE-ADDED TAX 165-316 (1974). The Michigan Department of Treasury has also recognized this characteristic of the tax. Single Business Tax Division, Michigan Dep't of Treasury, The New Single Business Tax 1 (Dec. 5, 1975), on file in the offices of Cleveland State Law Review. See also Barnes, The Business Receipts Tax, 32 MICH. ST. B.J. 31 (Oct. 1953).

205 See notes 6-37 supra and accompanying text.

206 Id.

207 In such a situation, the taxpayer receives a full cost deduction in one year and is only required to pay for the asset to the extent not financed by the loan. Depreciation deductions would more closely match the deduction taken for the cost of the asset with the cash paid over the life of the loan. Conversely, however, the use of depreciation penalizes the taxpayer that pays cash for assets since the deductions would be deferred over the depreciable life of the asset even though all of the cash is paid at the time of purchase. In any case, a full cost deduction allows deductions equal to or greater than the cash paid for the asset, on a year-by-year basis, whether the cash is paid all in the year of purchase or spread over the life of a loan. Depreciation often allows a deduction in the first year of an amount less than the cash paid, when the taxpayer pays cash for assets rather than financing them. Thus, a full cost deduction is more "generous" than depreciation in terms of the ability to pay maxim.
tion of five years. Because of its restrictive nature, businesses which sustain large losses for more than one or two years will often be unable to utilize the full carryforward before its expiration. Thus, the short time limitation operates to restrict the benefits of the carryforward to those businesses that suffer losses for only one or two years. Assuming that the policy behind the operating loss carryover is a sound one, it would seem that Ohio should consider bringing its carryover period in line with the federal (eight years) or the Michigan (ten years) time limitations.

D. "Persons" Subject to Taxation

The imposition of the SBTA on unincorporated businesses is one of the unique aspects of the new Michigan tax. In conjunction with the changes in the Michigan personal income tax, the parts of the SBTA applicable to unincorporated entities appear well-designed and effective. The fact that a state as large as Michigan has chosen to tax these entities when redesigning its entire business tax structure, should induce other states to consider such a tax. The advantage of the tax is that it provides another source of revenue for financially strained state governments, while requiring little legislative effort. Only minor changes in present business and personal income tax structures would be needed to effectuate the new tax in most states. The tax is an especially effective deterrent to the operation of unincorporated businesses by non-resident owners. Often personal income taxes are ineffective to tax the owners of these businesses because of their out-of-state residence, and the business income is not taxed at the entity level because the business is not

208 The policy is to equalize the treatment of taxpayers regardless of the pattern of their earnings over the years. For example, A and B earn the same total taxable income over a four year period, except that A's income varies widely from year to year. The tax rate is 10%. Compare the overall results with and without the operating loss carryover. The loss is carried here, until fully utilized. If a part of it had expired before A could fully utilize it, the results would appear more like those for A without a carryover provision at all.

<table>
<thead>
<tr>
<th>Year</th>
<th>Taxable Income</th>
<th>Tax at 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>19X1</td>
<td>$(50,000)</td>
<td>$5,000</td>
</tr>
<tr>
<td>19X2</td>
<td>$100,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>19X3</td>
<td>$(25,000)</td>
<td>$2,500</td>
</tr>
<tr>
<td>19X4</td>
<td>$75,000</td>
<td>$7,500</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$17,500</td>
</tr>
</tbody>
</table>

If the state allows carryforwards, both taxpayers pay the same total tax on the same total income. If there is no carryforward (or if it expires before utilized), A, as illustrated, pays a higher tax due only to the cyclical nature of its business, even though its income throughout the period is the same as the more stable B.

See generally Barley & Levy, Loss Carryback and Carryover Provision: Effectiveness and Economic Implication, 28 Nat'l Tax J. 173 (1975) comparing the "generosity" of the federal operating loss carryover with that used by other countries. Presumably, the analysis could be extended to compare the carryover provisions of one state with another.


210 Mich. Comp. Laws Ann. § 208.23(e) (Supp. 1976). Subchapter S corporations are taxed at the federal level much as partnerships are, even though they are organized as corporations. See Int. Rev. Code of 1954, §§ 1371-79.
incorporated. The tax on unincorporated businesses solves this problem by taxing the income of the business regardless of the owner's state of residence. It would appear that as states search for new sources of revenue, the tax on the income of unincorporated businesses may become more common, particularly if Michigan's tax proves successful.

Widespread taxation of the income of unincorporated businesses would, however, diminish the present attractiveness of that form of organization. Certainly one of the current advantages of the unincorporated form is the fact that its income has been ignored by the state and federal tax collectors. If this tax advantage is removed, it would seem that more businesses might be attracted to the corporate form of organization.

E. Interest on Underpayment and Overpayment of Tax

The SBTA provides that if the taxpayer underpays its tax, interest will be assessed on the deficiency at the rate of three-fourths of 1%211 per month, or 9% per year. The interest runs from the date the amount became due.213 Similar provisions are found in the Ohio214 and federal income tax statutes.215

The use of deficiency assessments216 prompts two questions. Are...
deficiency assessments effective in motivating the taxpayer to remit its payments on a timely basis? Are such assessments fair to the taxpayer? The first question is particularly important with respect to business taxes due to the large sums of money remitted by business taxpayers. Unlike their employees, businesses determine their own estimated tax payments\(^\text{217}\) and, thus, have a greater opportunity to manipulate and delay tax payments. A properly designed deficiency statute should minimize this problem.

The nature of the problem is readily illustrated by the following hypothetical. Suppose business taxpayer \(T\) is required to remit a $1,000,000 payment to the state on January 1. Suppose also that \(T\) is in a state that assesses only 6\% interest\(^\text{218}\) on delinquent payments and that \(T\) would have to pay 12\% interest to borrow the money for the payment in the marketplace.\(^\text{219}\) \(T\), with one eye on the deficiency rate of 6\% and the other on the market rate of 12\%, decides that it would be prudent tax planning to remit only $900,000 of the $1,000,000 payment that is due. The difference in the rates looks "too good to pass up" and \(T\) has only underpaid by 10\% ($100,000), an amount that is not likely to draw the attention of the state tax department.

If \(T\) can delay paying the $100,000 for a full year, it has a potential savings of $6,000.\(^\text{220}\) Thus, by setting the rate too low, the state has actually encouraged \(T\) to defer its payments as long as possible. It is less expensive to "borrow" from the state than to secure a loan in the marketplace.

The higher the prevailing market rate, the more lucrative this bit of tax planning becomes. Likewise, the larger the amount due, the more appealing is the delay in payment.\(^\text{221}\)

by the assessment, not to make a profit or to penalize the taxpayer, since other sections provide for penalties.


Employees' "estimated payments" are determined by the employer and withheld from the employees' paychecks. \(\text{Int. Rev. Code of 1954, \$ 3402;}\) \(\text{(id. \$ 6015 also requires certain individuals to estimate their own taxes in addition to the "estimate" made by the employer);}\)


\(^{218}\) As Ohio does. \(\text{Ohio Rev. Code Ann. \$ 5733.26(A) (Page 1973).}\)

\(^{219}\) The key indicator of the cost of money in the money market is the "prime rate of interest." It is defined as "[t]he interest rate most closely approximating the riskless or 'pure' rate for money, i.e., the highest quality credit... Rates on business loans of banks reflect... the size of the loan... maturities of loans... and geographical variations... " Munn's \text{Encyclopedia of Banking and Finance} 749 (7th ed. F. Garcia 1973). Thus, the prime rate is that charged to the bank's best customers. Loans with a higher risk level may involve rates of up to prime + 4\%. With prime rates reaching levels as high as 12\% in recent years, businesses have been paying 15-16\% for money in the market.

\(^{220}\) The potential tax savings is computed by taking the difference between the interest rate \(T\) must pay the state (6\%) and what it would pay to borrow the funds (12\%), times the amount to be borrowed (not remitted): \(12\% - 6\% = 6\%\); \(6\% \times \$100,000 = \$6,000\) savings.

\(^{221}\) The hypothetical is even more appealing if \(T\) can deduct the cost of the interest assessed for tax purposes. Of course, \(T\) could have deducted the cost of any interest paid for money borrowed in the market as an ordinary and necessary business expense.
the market rate or higher, \( T \) would rather pay the state since it is no more expensive than it is to borrow the money.

Despite the attractiveness of this tax planning device, \( T \) is somewhat limited in how much it can borrow from the state. If \( T \) consistently defers payments, the state may invoke an additional penalty for negligence or even fraud.\(^{222}\) Furthermore, at the end of its taxable year, when remittance of the full tax for the year is required, \( T \) must remit the full amount due. Therefore, this type of borrowing is restricted to a one-year duration. Of course, \( T \) can resume the "loan" by underpaying the estimated tax payment for the first quarter of the following year. Nevertheless, by fixing a deficiency rate in the statute, Michigan and Ohio have opened the door to abuses of the kind illustrated.

This problem can be avoided by an annual legislative review of deficiency interest rates in relation to market rates. If the statutory rates are set to equal or exceed the market rates, there will be no benefit to taxpayers who delay tax payments. In view of the widely fluctuating interest rates in recent years, such a legislative review appears necessary if the statute is to operate as intended. If the legislature is unwilling to assume the burden of annual review, it could delegate the duty to an administrative agency. Relatively simple guidelines could be provided for the agency, with the prime rate of interest as an indicator. The federal tax system employs an administrative review procedure.\(^{223}\)

Secondly, it must be asked whether it is fair to require taxpayers to pay interest on deficiency assessments. As a practical matter, such assessments merely reimburse the state for the use of money to which it was rightfully entitled. Any other result would reward the tardy taxpayer and penalize those making a good faith effort to comply. Furthermore, the government is equally fair with the taxpayer in the converse situation. The Michigan and federal statutes require those governments to pay interest to the taxpayer on any overpayments at the same rate charged for deficiencies if the refund is not made within 45 days of a

\[ \text{est on federal tax deficiencies is deductible for federal tax purposes. Rev. Rul. 70-284, 1970-1 Cum. Bull. 34.} \]
\[ \text{\( T \) can also deduct any state tax deficiency interest assessments on its federal return. 2 P-H 1976 Fed. Taxes } \]
\[ \text{\( \text{§} 13.023. \)} \]
\[ \text{Since the state taxes are based on federal taxable income, by deducting the state deficiency assessment at the federal level,} \]
\[ \text{\( T \) has also deducted it for state purposes unless the state tax specifically requires that the} \]
\[ \text{assessment be added back to income. Michigan provides that all taxes imposed by the} \]
\[ \text{SBTA and deducted for federal tax purposes } \]
\[ \text{\( \text{must be added back to income before figuring the SBTA tax. Mich. Comp. Laws Ann. } \text{§} 208.9(3) \text{ (Supp. 1976).} \)} \]
\[ \text{\"Taxes\" are defined to include interest on taxes. Id. } \text{§} 208.8. \text{ Thus, interest deficiency assessments on SBTA} \]
\[ \text{taxes could be deducted for federal tax purposes but not for SBTA purposes. (The SBTA also disallows deductions for interest in general. See note 154 supra and accompanying text.)} \]
\[ \text{Ohio does not provide for the adding back of its own tax or the interest thereon. See Ohio Rev. Code Ann. } \text{§} 5733.04(1) \text{ (Page Supp. 1976).} \]
\[ \text{Therefore, } \text{T would deduct Ohio} \]
\[ \text{interest assessments on its federal tax return, and this deduction would flow through to its} \]
\[ \text{Ohio return. Thus, indirectly, Ohio does allow for the deduction of its own interest ass} \]
\[ \text{essments, making the hypothetical even more attractive.} \]

\[ \text{\( \text{\( \text{\footnote{For penalties in Michigan, see Mich. Comp. Laws Ann. } \\text{§§ 208.81(4), (5) (Supp. 1976).} \text{Ohio does not provide for such} \text{penalties. See Ohio Rev. Code Ann. } \text{§} 5733 \text{ (Page Supp. 1976).} \text{footnote 222)}} \text{See Int. Rev. Code of 1954, } \text{§} 6621.} \text{footnote 223} \]
claim for it.224 Ohio is even more generous, granting 6% interest from the date of the overpayment.225 This approach, however, places an unduly heavy burden on the Ohio Tax Commissioner to review and process payments quickly in order to reduce interest paid.226 A statute similar to Michigan's appears more reasonable in view of the number of refund claims processed and the complexity of determining their accuracy.

Thus, in a market with fluctuating interest rates, fixed rates in a state's tax deficiency statute may lead to results inconsistent with the intended goals of compensating the state for late tax remittances and motivating timely payments by taxpayers. The flexible rates in the federal statute are an effective and practical answer to the problem and both Michigan and Ohio should note this rather simple solution.

F. The Rate of Tax

The SBTA tax rate is 2.35% of the adjusted tax base of the taxpayer.227 The proponents of the tax estimated that it would generate revenues of about $800 million, approximately the revenue of the taxes it replaced;228 nevertheless, there is already a proposal in the Michigan legislature to raise the rate to 2.5%.229

The imposition of a 2.35% tax is not terribly significant in relation to the 48% imposed by the federal tax and the rates of other industrial states which often range over 10%.230 It must be remembered, however, that the other tax rates are imposed on net income. Michigan's is imposed on the Michigan tax base, in which there is no deduction for compensation or interest. The tax base can range as high as 50% of gross receipts before any relief is offered by the statute. In such a case, 2.35% of 50% of gross receipts can yield a much larger tax than 10% of net income. Thus, it is not possible to compare other states' statutory rates with the SBTA's because their definition of taxable income is so different. In the face of this difference, the economic impact of the tax can only be effectively judged after the tax has been in effect for at least a year.

V. Conclusion

With the enactment of the SBTA, Michigan has become one of the few states to develop an overall scheme for the taxation of business activity. Rather than attempt to change the patchwork system that had been in
effect, the legislature repealed the variety of business taxes then in use in order to substitute a single, well-designed tax. While the merits of the tax Michigan enacted may be debated, all should agree that such a comprehensive re-evaluation is admirable.

The SBTA has the major characteristics of an income tax, yet there are adjustments disallowing interest and compensation expenses as deductions. This gives the SBTA some of the qualities of a value-added tax and is certain to provoke discussion. Industries and businesses with significant interest and compensation expenditures will find the provisions less than appealing. Along with the full cost deduction for capital assets acquired, the least that can be said about the SBTA is that it is very different from what is in use in other states. Because of the SBTA’s uniqueness, the effect of the novel provisions must await at least the first year of experience. Perhaps the greatest disappointment is that Michigan has refused to comply with the MTC which equitably allocates the income of multistate businesses. These businesses will continue to be unfairly taxed because states like Michigan refuse to adopt without modification the reasonable solution provided by the MTC.

The SBTA serves as a model for Ohio to the extent that it advocates re-evaluation and streamlining of the business tax structure. Like Michigan, Ohio’s business tax structure has evolved over a long period of time. As additional revenues were needed, additional taxes were levied and additional complications arose. Perhaps the best example of this lack of planning is the continued use of the tax on corporations based upon the higher of the franchise tax or the income tax. This imposes the cost and inconvenience of two separate computations on every taxpayer within the state. It would appear that the system could be greatly simplified if the state would rely on the income tax alone. Appropriate rate changes could be used to maintain the present level of revenues.

Whether the SBTA serves as a model tax for Ohio in other respects is doubtful. Ohio already has a well-designed income tax. The SBTA is complex, both in practice and theory, and the benefits to be obtained over a well-designed income tax are questionable. Whether the SBTA has some of the benefits of both income and value-added taxes or the advantages of neither, remains to be seen. The one clear problem with the SBTA is its complexity. It would seem that Ohio would be better advised to repeal its franchise tax and make relatively minor changes in its income tax, rather than change its entire system to one such as the SBTA, in which the complexities and problems are assured and the benefits remain to be proven.

Robert M. Wilson