taxnotes® state

Volume 100, Number 7 ■ May 17, 2021

Vectren: The Most Cogent Alternative Apportionment Decision in Years

by Joshua A. Labat, Zachry T. Gladney, and Clark R. Calhoun

Reprinted from *Tax Notes State*, May 17, 2021, p. 709

Vectren: The Most Cogent Alternative Apportionment Decision in Years

by Joshua A. Labat, Zachry T. Gladney, and Clark R. Calhoun

Joshua A. Labat

Zachry T. Gladney

Clark R. Calhoun

Joshua A. Labat is an associate and Zachry T. Gladney is a partner with Alston & Bird LLP in New York, and Clark R. Calhoun is a partner in the firm's Los Angeles and Atlanta offices.

In this installment of Audit & Beyond, the authors examine aspects that the Michigan Court of Appeals' decision in *Vectren* add to the alternative apportionment discussion and provide commentary regarding proper resolution in situations — as in *Vectren* — in which alternative apportionment is found to be appropriate.

Though it has its fair share of detractors, the single-sales-factor (SSF) apportionment formula has become a fixture in the state tax landscape. Last year, Walter Hellerstein published an article in these pages in which he traced the history of constitutional challenges to SSF formulas and asked whether their proliferation has made them "more vulnerable to attack as a theoretical and practical matter."[1] Hellerstein identified some tension in the jurisprudence, noting on the one hand that courts have applied a "relaxed standard of review" to constitutional challenges to formulary apportionment, while on the other hand they have questioned the "wisdom" of the SSF.[2] In support of the latter point, he referred to the U.S. Supreme Court's decision in *Moorman*, in which the Court stated that the use of the SSF "in the context of the [then] more prevalent three-factor formula would not advance the policies underlying the Commerce Clause."[3] Yet despite the Court's expression of concern over the use of the SSF in *Moorman*, it upheld Iowa's SSF as applied in that case.

In light of that history — and possibly as a response to the perception that the constitutionality of the SSF is settled — Hellerstein pointed to a "tantalizing" open question: "What might have happened in *Moorman* if the taxpayer had in fact mounted a serious 'as applied' challenge to Iowa's single sales factor . . . ?"[4] He then pivoted to discuss a

[1] Hellerstein, "Distortion of Income in a Single-Factor Sales Formula World," *Tax Notes State*, May 11, 2020, p. 729.

[2] *Id.* at 732.

[3] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 274-275 n.8 (1978) (discussing *General Motors Corp. v. District of Columbia*, 380 U.S. 553 (1965)).

[4] Hellerstein, *supra* note 1, at 734.

recent case, *Vectren Infrastructure Services*,[5] which provides a rare cogent analysis of an as-applied constitutional challenge to the SSF.

We return to the issues discussed by Hellerstein to analyze additional aspects that the Michigan Court of Appeals' decision in *Vectren* add to the alternative apportionment discussion and also to add commentary regarding appropriate resolution in situations — as in *Vectren* — in which alternative apportionment is found to be appropriate.

Moorman

As a quick refresher, the taxpayer in *Moorman* was an Illinois-based manufacturing company engaged in manufacturing and in the sale of animal feeds.[6] During the tax years in dispute, the taxpayer's sales in Iowa accounted for approximately 20 percent of its total sales.[7] At the time of the taxpayer's challenge, Iowa used an SSF, which resulted in approximately 22 percent of the taxpayer's total sales being apportioned to Iowa.[8] Had Iowa used the then-common three-factor formula of property, payroll, and sales, the taxpayer's Iowa apportionment percentage would have been around 14 percent.[9]

After receiving an assessment and having its appeal rejected by the Iowa Tax Commission, the taxpayer challenged the constitutionality of Iowa's SSF in state court.[10] The trial court held that Iowa's SSF was invalid under both the due process clause and the commerce clause of the U.S. Constitution.[11] But the state appealed to the Iowa Supreme Court, which reversed.[12]

At the U.S. Supreme Court, the taxpayer advanced two arguments why Iowa's SSF violated the due process clause. First, the taxpayer's Illinois operations were responsible for some of the sales generated in Iowa.[13] Second, Moorman argued that "a formula that reaches any income not in fact earned within the borders of the taxing State violates due process."[14] The Court rejected the taxpayer's due process clause argument, stating that the taxpayer's premise was "speculative" and was "foreclosed by prior decisions of this Court."[15]

The Court also rejected the taxpayer's commerce clause argument on two grounds. First, the taxpayer failed to demonstrate that "Illinois and Iowa together imposed a tax on more than 100 percent of the relevant net income."[16] Second, after acknowledging "some overlap" in the taxation of the taxpayer's income by both Iowa and Illinois, the Court "could not accept [Moorman's] argument that Iowa, rather than Illinois, was necessarily at fault in a constitutional sense."[17] The Court concluded that:

> since the record does not reveal the sources of [Moorman's] profits, its Commerce Clause claim cannot rest on the premises that profits earned in Illinois were included in its Iowa taxable income and therefore the Iowa formula was at fault for whatever overlap may have existed.[18]

The Court's Analysis in *Vectren*

Moorman was a taxpayer loss, at least in part, because the taxpayer made only a facial challenge to Iowa's SSF. But what if a taxpayer took a different approach to a state's SSF and made an as-applied challenge to the statute? Just such a case occurred in the Michigan Court of Appeals in

---

[5] *Vectren Infrastructure Services Corp. v. Department of Treasury*, 331 Mich. App. 568, 953 N.W.2d 213 (2020), *vacated and remanded on other grounds*, 950 N.W.2d 746 (Mich. 2020) (vacating decision and remanding to court of appeals to review "foundational" issue of proper method for calculating business tax that should have been reviewed before reaching the alternative apportionment issue). The court of appeals, acknowledging that it is preferred that a trial court be given the opportunity to address an issue before appellate review, has remanded the case to the court of claims on a priority basis, while retaining jurisdiction. The court of claims has ordered additional briefing.

[6] *Moorman Mfg. Co.*, 437 U.S. at 269.

[7] *Id.*

[8] *Id.* at 271, n.4.

[9] *Id.*

[10] *Id.* at 271.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 271-272. Illinois — where Moorman was based — applied a three-factor formula, meaning that it taxed a portion of Moorman's property and payroll that contributed to its Iowa sales.

[14] *Id.*

[15] *Id.* at 272.

[16] *Id.* at 276.

[17] *Id.* at 277.

[18] *Id.*

Vectren,[19] and it rightly drew the attention of Hellerstein — as well as our attention.

In *Vectren,* the taxpayer, Minnesota Ltd. Inc. (MLI),[20] was a Minnesota-based S corporation engaged in constructing, maintaining, and repairing oil and gas pipelines.[21] The taxpayer operated in upper Midwest states, primarily in Minnesota, Iowa, and the Dakotas.[22] While the taxpayer had some operations in Michigan, they were comparatively small, accounting for no more than around 7 percent of its total business in the decade before the tax year litigated.[23]

In 2010 the taxpayer began working in Michigan on an oil pipeline spill project, using mostly rented equipment and Michigan union employees; the court recognized that MLI never maintained a place of business or permanent employees in Michigan.[24] That project continued into 2011 and became MLI's primary revenue driver in the early part of the year. While MLI's Michigan project was ongoing, it sold its stock in March 2011 for $80 million and made a section 338(h)(10) election.[25] In accordance with its reading of Michigan law, MLI included the gain from the sale in its Michigan tax base for the short tax year from January 1 through March 31, 2011, and it included the receipts from the sale in the denominator of its apportionment factor, yielding a Michigan apportionment factor of about 15 percent.[26]

In 2014 the Michigan Department of Treasury audited MLI. The department retained the inclusion of Michigan business tax (MBT) gain in the pre-apportioned tax base, but it excluded the gain from the denominator of the MBT sales factor, apparently determining that the standard formula required the exclusion of occasional or extraordinary sales from the factor.[27] The auditor's adjustment resulted in an increase in MLI's Michigan SSF from approximately 15 percent to 70 percent (that is, the percentage of sales receipts that MLI had generated in Michigan during the short year when it had an atypical concentration of Michigan business).

The taxpayer submitted an alternative apportionment request for the short year to the department, asserting either that the gain should be sourced to Minnesota or not taxed at all, because sourcing the gain to Michigan would unreasonably attribute the long-term gain from the sale of MLI's assets (nearly all of which were located outside Michigan at all times) to Michigan.[28] It also contended that the income might properly be treated as nonbusiness income. The department denied the request, responding that its adjustment was appropriate because (1) the taxpayer's 2011 business activities in Michigan contributed to the gain from the sale and because (2) a sale of a business was "not an unusual fact situation" that justified a deviation from the standard apportionment formula.[29]

On appeal, the Michigan Court of Appeals reversed, stating that:

> application of the statutory formula in this case runs afoul of the Due Process and Commerce Clauses, incorporated in the [MBT] statute, because it does not fairly determine the portion of income from the Sale that is reasonably attributed to in-state activities. Fairness, in part, requires that the "choice of factors used in the formula must actually reflect a reasonable sense of how [the business activity] is generated." Looking only at the Short Year does not actually and reasonably reflect how the income from the Sale was generated.[30]

---

19 *Vectren Infrastructure Services*, 331 Mich. App. The fact that the original court of appeals decision was vacated presumably eliminates the binding nature of the decision in Michigan, but in our view, it should not have a material effect on the potential persuasive impact of the decision in other states.

20 Vectren Infrastructure Services Corp. is the successor in interest of MLI.

21 *Vectren Infrastructure Services*, 331 Mich. App. at 570.

22 *Id.* at 571.

23 *Id.* at 571 and 583.

24 *Id.* at 571.

25 *Id.* at 571-572.

26 *Id.* at 572.

27 *Id.*

28 A large portion of the gain was attributable to goodwill, which should have been sourced to the taxpayer's commercial domicile in Minnesota.

29 *Vectren Infrastructure Services*, 331 Mich. App. at 573-574.

30 *Id.* at 583-584 (quoting *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983)).

The court's analysis went on to say that because the value of the business was built up over a long period through activity in many states — and primarily *outside* Michigan — the SSF as applied to MLI's short year operated "so as to reach profits which are in no just sense attributable to" Michigan.[31] The problem is then compounded, the court wrote, when "the Sale occurred during a period (the Short Year) in which an unusually large percentage of the business activity occurred in Michigan."[32]

The court found it troubling that the MBT's SSF resulted in an "allocation of 70% of the gain of the Sale to Michigan," while "the undisputed history of MLI's sales in the state is that those sales averaged around 7% of its total sales."[33] The court concluded that "to impose tax on 70% of the gain of the Sale is not commensurate with the 'protection, opportunities and benefits' that Michigan conferred on MLI,"[34] adding that looking to the short year's "unusual concentration" of activity in Michigan yielded an "unconstitutional distortion."[35] It therefore held that alternative apportionment was appropriate in that "exceptional case."[36]

The *Vectren* Court Misses the Extra Point

In his article a year ago, after examining *Vectren*, Hellerstein noted that this case may be a "harbinger of things to come" for taxpayers challenging SSFs, but that it is premature to conclude that courts will generally be more "receptive" to taxpayers' SSF challenges.[37] We agree that it is too soon to say what *Vectren* will mean for future SSF challenges, but taxpayers, states, and advocates should take note of the taxpayer's victory and seek other opportunities to take advantage of the Michigan Court of Appeals' rationale and holding. If nothing else, *Vectren* provides authority in support of what should be one context in which alternative apportionment relief is common — that is, when the result under a state's standard formula is demonstrably "unusual" when seen through the lens of the taxpayer's history of sales activity in the state. *Vectren* involved a sale with a significant capital gain, but there is no reason that its impact and reasoning should be limited to extraordinary exit events; rather, its rationale should have some persuasive force any time a taxpayer's sales in one year are out of step with its historical sales and other markers of business presence in a state.

What *Vectren* does better than perhaps any alternative apportionment case outside the treasury-function precedents in California is to identify specifically why the SSF failed: Namely, because the "unusual concentration" of sales in the taxpayer's short year led to distortion under MLI's "exceptional" facts. Our praise for the decision, however, is not without its limits. The *Vectren* court reached the end zone with its appreciation for the purposes of alternative apportionment and its explanation for why alternative apportionment was appropriate on the facts of the case, but it botched the extra point: After identifying the precise cause of the distortion in the standard SSF on the taxpayer's facts, the court declined to get involved in prescribing the remedy, which should have been the selection of the appropriate alternative apportionment formula. The court instead deferred to the parties to settle the matter, saying that "this matter must be returned to the Department for the determination of the appropriate alternate method to be used. We encourage the parties to engage in a good-faith collaboration to arrive at such a method."[38]

But the right answer should have been clear to the court of appeals: If the distortion was the result of the "unusual concentration of activity in Michigan" during the short tax year in which the sale of the business occurred,[39] the remedy was to use a broader set of data, including "usual" sales

[31] *Id.* at 584.

[32] *Id.* at 579.

[33] *Id.* at 583.

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] Hellerstein, *supra* note 1, at 736.

[38] *Vectren Infrastructure Services*, 331 Mich. App. at 586. Following the court of appeals' decision, the state appealed to the Michigan Supreme Court, which vacated the decision and remanded to the court of appeals to evaluate whether the standard apportionment formula was properly applied in the first place. Specifically, the supreme court left the court of appeals to determine if the gain should have been included in the denominator or excluded from the tax base, and whether there was any need to resort to alternative apportionment.

[39] *Id.* at 583.

data from other tax years.[40] Stated another way, when a court finds that alternative apportionment is appropriate, then the solution should be baked right into the reason that justified the use of alternative apportionment. For example, on the fact pattern on which the treasury-function cases were based, the problem with the standard formula was that the denominator could be artificially inflated by the churning of receipts that did not yield any material income; the answer, therefore, was to remove those gross receipts from the factor.

A recent decision from Washington addressed this second prong of an alternative apportionment petition more deftly than the *Vectren* court. In *KMS Financial Services*, the taxpayer, a Seattle-based investment advisory business and an SEC-registered broker-dealer, made an as-applied challenge to the city of Seattle's business and occupation (B&O) tax.[41] The taxpayer generated income through the sale of securities by both Form W-2 employees and Form 1099 independent contractors.[42] Because of securities law, the taxpayer exercised the same level of control over the sales activities of both its Form W-2 employees and Form 1099 independent contractors.

For the tax years at issue, the taxpayer paid its Form W-2 employees over $6 million, with approximately 95 percent of compensation going to the taxpayer's 50 Seattle-based employees.[43] During the same period, the taxpayer paid almost $180 million in commissions to its independent contractors, with approximately 85 percent of commissions going to the taxpayer's 300-plus independent contractors located outside Seattle.[44] When the taxpayer calculated its payroll factor for the B&O tax, it included the commissions that it paid to its independent contractors in the denominator of the payroll factor.[45] Because approximately 85 percent of the taxpayer's independent contractors worked outside Seattle, the taxpayer's reported payroll factor was between 14 and 20 percent.[46] Based on these percentages, the taxpayer reported and paid approximately $180,000 in Seattle B&O tax for the tax years at issue.[47]

During an audit of the taxpayer, the city excluded all the independent contractors' commissions from both the numerator and denominator of the payroll factor, arguing that payments to independent contractors were not included in computation of the B&O payroll factor. This adjustment had the effect of increasing the taxpayer's payroll factor to close to 100 percent.[48] The taxpayer paid the tax and filed a refund claim, arguing that if the standard apportionment formula did not permit inclusion of amounts paid to independent contractors, alternative apportionment was appropriate because payments to its employees and independent contractors were made for similar work performed under similar control, and it was distortive not to give any factor relief for the substantial work performed by its independent contractors, most of whom were located outside Seattle.[49]

The Washington Court of Appeals affirmed the request, holding that Seattle's B&O tax was not fairly apportioned and therefore unconstitutional as applied to the taxpayer.[50] The court agreed with the taxpayer's argument, determining that the B&O tax was not externally consistent as applied to the taxpayer because the city failed to consider where and how the taxpayer generated its income — that is, mostly through independent contractors located outside Seattle.[51] The court highlighted the fact that the city ignored where the taxpayer's independent contractors generated income for the taxpayer and therefore incorrectly included only the taxpayer's employees in the payroll factor.[52] Stated another way, the court

[40] The taxpayer proposed various options to the court of appeals, including a 10-year average of its Michigan sales.

[41] *City of Seattle v. KMS Financial Services Inc.*, 12 Wash. App. 2d 491 (2020).

[42] *Id.* at 495-496.

[43] *Id.* at 498.

[44] *Id.*

[45] *Id.* at 500.

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.* at 500 and 507-508.

[50] *Id.* at 506.

[51] *Id.*

[52] *Id.*

identified the distortion-causing basis for alternative apportionment (that is, the failure of the payroll factor to represent the full set of payees that were involved in the performance of services for the taxpayer) and then applied a remedy that would solve for that distortion (that is, a more inclusive payroll factor).

Conclusion

While *Vectren* provides valuable new authority that can be used to support challenges to SSF formulas, the Michigan Court of Appeals regrettably dodged the fairly easy question of how best to resolve the case after it had cogently identified the reason why the standard SSF formula was not reasonable as applied in the first place. Because of the Michigan Supreme Court's remand, however, it has another opportunity to do so. We hope that it will add to the still surprisingly thin body of alternative apportionment decisions and — consistent with the Washington decision in *KMS Financial* — affirm that when alternative apportionment is appropriate, the best remedy is to choose the alternative apportionment method that solves for the distortion that had justified the use of alternative apportionment. ■