

**STATE OF MICHIGAN**  
**COURT OF APPEALS**

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TAD MALPASS and BRENDA L. MALPASS,  
Plaintiffs-Appellees,

UNPUBLISHED  
December 6, 2011

v

No. 299057  
Court of Claims  
LC No. 08-000065-MT

DEPARTMENT OF TREASURY,  
Defendant-Appellant.

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TRACY MALPASS and BRENDA K.  
MALPASS,

Plaintiffs-Appellees,

v

No. 299058  
Court of Claims  
LC No. 08-000066-MT

DEPARTMENT OF TREASURY,  
Defendant-Appellant.

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FRED MALPASS and BARBARA MALPASS,

Plaintiffs-Appellees,

v

No. 299059  
Court of Claims  
LC No. 08-000067-MT

DEPARTMENT OF TREASURY,  
Defendant-Appellant.

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Before: SHAPIRO, P.J., and SAAD and BECKERING, JJ.

PER CURIAM.

In this consolidated appeal, the Michigan Department of Treasury appeals the June 9, 2010 judgment of the Court of Claims that reversed the Treasury's decision to deny plaintiffs'

amended individual income tax returns for the years 2001, 2002, and 2003. For the reasons set forth below, we reverse.

## I. FACTS AND PROCEEDINGS

Plaintiffs own and control East Jordan Iron Works, Inc. (EJIW). EJIW is a Michigan corporation with its corporate offices, resident agent, and principle place of business located at 301 Spring Street, East Jordan Michigan. During the years in question, EJIW operated a foundry in East Jordan. In 1999, plaintiffs established Ardmore Foundry, Inc. (Ardmore). Ardmore is a Michigan corporation with its resident agent located at 301 Spring Street, East Jordan. However, Ardmore's sole business is the ownership and operation of a foundry and distribution center known as EJIW-Ardmore Foundry, located in Ardmore, Oklahoma. All of Ardmore's stock is owned directly, or through trust, by members of the Malpass family.

Both EJIW and Ardmore have elected to be treated as S corporations for federal tax purposes. "Consequently, neither EJIW nor Ardmore pays federal income taxes. Instead the income or loss of each corporation is passed through to its shareholders and reported by its shareholders on their individual and Michigan income tax returns." In the years 2001, 2002, and 2003, plaintiffs filed their Michigan individual income tax returns "treating the business income from EJIW and Ardmore as from separate, non-unitary businesses." Accordingly, plaintiffs apportioned their business income from EJIW attributable to Michigan and included it as income on their Michigan individual income tax returns. The losses incurred by Ardmore were attributed to Oklahoma and added back into plaintiffs' adjusted gross income for Michigan individual income tax purposes.

Plaintiffs later filed amended individual income tax returns for the years 2001, 2002, and 2003. In their amended returns, plaintiffs treated EJIW and Ardmore as a unitary business and applied the Michigan apportionment factors to both companies as a unitary business. In so doing, plaintiffs sought to offset gains earned by EJIW with losses incurred by Ardmore. Through their amended returns, plaintiffs requested refunds totaling over one million dollars.

The Treasury denied plaintiffs' amended returns, and each plaintiff filed an appeal in the Court of Claims requesting reversal. The three cases were consolidated by stipulation of the parties. After submitting a partial stipulation of facts, the Treasury moved for summary disposition and argued that the Michigan Income Tax Act (ITA), MCL 206.1 *et seq.*, does not allow the unitary business principle to be applied to individual income tax situations. The Treasury also asserted that there is no basis under the ITA for plaintiffs to use a combined filing method based on the unitary business principles.

Plaintiffs opposed the Treasury's motion and asked the court to grant summary disposition in their favor. Plaintiffs argued that EJIW and Ardmore are a unitary business and supported the motion with an affidavit from William Lorne, treasurer of EJIW, who averred that the two companies are functionally integrated. After hearing arguments, the Court of Claims issued a written opinion and order dated November 19, 2009, granting summary disposition to plaintiffs. The Court of Claims stated that although the Legislature had not explicitly referenced the unitary business principle in the ITA, it nonetheless adopted the principle into the act. The court based its conclusion on MCL 206.110(1), which provides: "For a resident individual . . .

all taxable income from any source whatsoever, except that attributed to another state under sections 111 to 115 and subject to section 255, is allocated to this state.” The court noted that MCL 206.111-.114, and MCL 206.255 are not applicable, but that MCL 206.115 provides: “All business income, other than income from transportation services shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.”

Taking MCL 206.110 and MCL 206.115 together, the court stated: “Clearly, based on the plain language set forth in Sections 110 and 115, the Michigan Legislature has adopted the unitary business principle, because it has chosen to require apportionment of all business income according to a statutory formula.” The Court of Claims further observed that the language of MCL 206.115 is so broad that it does not distinguish between unitary and non-unitary businesses. However, the court recognized that the ITA’s apportionment formula can only be constitutionally applied to a unitary business. Because it ruled that plaintiffs’ businesses are unitary, the court allowed apportionment and ordered the Treasury to make the requested refunds.

## II. DISCUSSION

This Court reviews the grant or denial of a motion for summary disposition de novo. *Int’l Business Machines v Dep’t of Treasury*, 220 Mich App 83, 86; 558 NW2d 456 (1996). To the extent this appeal requires us to interpret the ITA, our review is also de novo. *Briggs Tax Serv, LLC v Detroit Pub Sch*, 485 Mich 69, 75; 780 NW2d 753 (2010).

We hold that the Court of Claims erred when it ruled that the unitary business principle allows plaintiffs to apportion their business income from Ardmore to Michigan.

Although the US Constitution does not impose a single tax formula on the states, apportionment is often implemented because of the difficulties of attempting to allocate taxable income based on geographic boundaries. *Allied-Signal, Inc v Dir, Div of Taxation*, 504 US 768, 778; 112 S Ct 2251; 119 L Ed 2d 533 (1992); *Container Corp of America v Franchise Tax Bd*, 463 US 159, 164; 103 S Ct 2933; 77 L Ed 2d 545 (1983). Because of these difficulties, states are permitted to tax multistate businesses “on an apportionable share of the multistate business carried on in part in the taxing State.” *Allied-Signal*, 504 US at 778. This is known as the “unitary business principle.” *Id.* Utilizing the unitary business principle, Michigan has incorporated an apportionment formula into the ITA. MCL 206.110(1) provides: “For a resident individual . . . all taxable income from any source whatsoever, except that attributable to another state under sections 111 to 115 and subject to section 255, is allocated to this state.” As noted, MCL 206.115 provides: “All business income . . . shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.” “The property, payroll, and sales factors represent the percentage of the total property, payroll, or sales of the business used, paid, or made in this state.” *Grunewald v Dep’t of Treasury*, 104 Mich App 601, 606; 305 NW2d 269 (1981), citing MCL 206.116, .119, .121.

For an individual or business to apply the unitary business principle, there must “be some sharing or exchange of value not capable of precise identification or measurement—beyond the

mere flow of funds arising out of a passive investment or a distinct business operation—which renders formula apportionment a reasonable method of taxation.” *Container Corp of America*, 463 US at 166. In the absence of some underlying unitary business, multistate apportionment is precluded. *Holloway Sand & Gravel Co Inc, v Dep’t of Treasury*, 152 Mich App 823, 829-830; 393 NW2d 921 (1986). To determine whether there is a unitary business, this Court looks at (1) economic realities, (2) functional integration, (3) centralized management, (4) economies of scale, and (5) substantial mutual interdependence. *Id.* at 831.

Here, plaintiffs argue that they are allowed to apportion their income from Ardmore and EJIW because the two corporations form a unitary business. Based on Lorne’s affidavit, there is no doubt that Ardmore and EJIW have many characteristics of a unitary business. See *Holloway*, 152 Mich App at 830-835. However, they remain separate and legally distinct business entities, and nothing in the ITA allows for combined entity reporting.

The Court of Claims focused on the word “all” in MCL 206.115, and ruled that it meant that all business income, no matter what the source, be added together and then apportioned by the apportionment factors. The problem with this approach, which the Court of Claims recognized, is that “[u]nder both the Due Process and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, ‘tax value earned outside its borders.’” *Container Corp of America*, 463 US at 164 (citation omitted). Therefore, under the Court of Claims’ approach, in order to comply with due process, business income may only be combined if the separate entities operate in a unitary fashion. If business income is earned from entities that do not operate in a unitary fashion, then the income must be apportioned at the entity level, with each entity analyzed separately. While this approach may be constitutionally permissible, it would cause MCL 206.115 to be applied inconsistently as to different taxpayers.<sup>1</sup> In contrast, a consistent approach would be to apportion all business income at the entity level. That way, if the business conducts multistate activity, the income will be apportioned accordingly. If the business has no nexus to Michigan, none of that income will be attributed to Michigan because its property factor, payroll factor, and sales factor will all be zero. See *Grunewald v Dep’t of Treasury*, 104 Mich App at 606.

Plaintiffs, however, argue that EJIW and Ardmore’s separate entity status does not matter because they nonetheless form a unitary business. Plaintiffs rely on *Holloway* and on *Jaffe v Dep’t of Treasury*, 172 Mich App 116; 431 NW2d 416 (1988) to support their position. These

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<sup>1</sup> The difficulty appears to lie in the ability to consistently apply the unitary business principle to legally separate entities. For example, a petitioner who holds interests in multiple separate entities could attempt, on one hand, to exclude his out-of-state businesses that turn a profit from inclusion and apportionment, while arguing on the other hand that his other out-of-state businesses that post a loss should be included and apportioned to his advantage. Given the myriad of business organization and management options and the somewhat broad factors used in *Holloway* to determine whether to apply the unitary business principle, it is difficult to see how the Court of Claims’ approach would result in anything other than arbitrary decisions and unnecessary protracted litigation.

cases, however, are distinguishable because they did not deal with multiple-entity apportionment. Rather, they each involved a single entity trying to utilize the unitary business principle to apportion income for business activities conducted in other states. *Holloway*, 152 Mich App at 826; *Jaffe*, 172 Mich App at 117.

Plaintiffs also rely on *Glieberman v Dep't of Treasury*, 14 MTTR 223 (Docket No. 288104, July 11, 2003), to support their argument that the separate entity status of EJIW and Ardmore is insignificant. In *Glieberman*, the petitioner was the sole shareholder of Strathmore Finance Company, Inc. (Strathmore), a qualified subchapter S corporation. *Id.* at 3. Strathmore was the parent company of Tralon Corporation, a qualified subchapter S subsidiary (QSub). *Id.* at 1, 3. Tralon Corporation earned income from two joint venture LLCs located in Arizona and California, which was then passed up to the petitioner through Strathmore. *Id.* at 3-4. The Treasury argued that the petitioner's business income from the two LCCs was apportionable to Michigan under the ITA, but the tax tribunal held that the income passed up from the LCCs could not be apportioned to Michigan because the LCCs did not form part of a unitary business with Tralon. *Id.* at 9-10.

Plaintiffs argue that the tax tribunal did not allow the separate entity nature of the businesses in *Glieberman* to defeat the ITA's mandate to apportion business income as long as the entities form part of a unitary business. Plaintiffs assert that the tribunal indicated apportionment would be required if the entities formed a unitary business, despite the fact that they were legally separate entities. *Glieberman*, however, is distinguishable because it involved a qualified subchapter S subsidiary. Here, unlike the businesses in *Glieberman*, Ardmore is not a qualified subchapter S subsidiary of EJIW because Ardmore's stock is not owned by EJIW, but "directly or through trusts, by members of the Malpass family." IRC 1361(b)(3)(B)(i). Therefore, plaintiffs' reliance on *Glieberman* is misplaced. Despite the unitary characteristic of EJIW and Ardmore, they are separate legal entities. There is no provision in the ITA that allows individuals to combine their business income from separate businesses and then use a combined apportionment formula on the total.

This is further supported by the Treasury rules. Rule 206.12 provides in part:

(1) Salaries, wages, and other compensation received by a Michigan resident are allocated to Michigan.

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(3) Income from a trade or business as defined in R 206.1 is allocated or apportioned to the state in which the activity takes place.

(4) Business income that is attributable to Michigan and 1 or more other states shall be apportioned as provided in sections 115 to 195 of Act No. 281 of the Public Acts of 1967, as amended, being §§206.115 to 206.195 of the Michigan Compiled Laws. [1979 AC, R 206.12(1), (3-4).]

Starting with the premise that all compensation received by a Michigan resident is allocated to Michigan, which is in conformance with MCL 206.110(1), Rule 206.12(3) then provides that business income is allocated or apportioned to the state in which the activity took place.

Therefore, if a resident earns business income that is derived from another state, it is allocated to that state. However, if the business income is attributable to Michigan and one or more other states, 1979 AC, R 206.12(4) provides that it is apportioned as required under ML 206.115.

As applied to this case, plaintiffs' income from Ardmore (which includes losses) is attributed to the state in which the activity took place—Oklahoma. Rule 206.12(3). Because the losses sustained by Ardmore are not attributable to Michigan, they are not allocated or apportioned to Michigan and are added back to plaintiffs' adjusted gross income. Rule 206.12(20) ("Distributive income from a subchapter S corporation not allocated or apportioned to Michigan may be claimed as a subtraction from adjusted gross income. Conversely, losses not allocated or apportioned to Michigan shall be added to adjusted gross income.").

Plaintiffs argue that apportionment is required under *Preston v Dep't of Treasury*, \_\_\_Mich App\_\_\_; \_\_\_NW2d\_\_\_ (2011) (Docket No. 295055, issued May 26, 2011). *Preston*, however, is distinguishable. In *Preston*, the plaintiff owned Life Care Affiliates II (LCA II), a Tennessee Limited Partnership. *Id.* at slip op p 1. LCA II was general partner in 22 lower level partnerships that operated 27 nursing homes. *Id.* One of the lower level partnerships was Riverview Medical Investors LP (RMI), which owns two nursing homes in Michigan. *Id.* at slip op pp 1-2. The remainder of the partnerships had no business activity in Michigan. *Id.* at slip op p 2.

All 22 partnerships distributed gains and losses to LCA II, which in turn distributed the combined income to the plaintiff. When reporting his Michigan income, the plaintiff took the gains received from RMI and offset them with losses suffered by other partnerships. *Preston*, slip op p 2. The Treasury argued that the plaintiff could not offset his Michigan income from RMI with losses incurred by other partnerships because they had no activity in Michigan. *Id.* at slip op p 2. This Court, however, ruled that apportionment was proper because LCA II operated the partnerships as a unitary business. *Id.* at slip op pp 3-5.

Plaintiff asserts that *Preston* supports apportionment in this case. *Preston*, however, addressed partnerships, not corporations. And in *Preston*, the 22 lower level partnerships were all operated together through LCA II, which owned a 99 percent interest in the 22 partnerships. Although each of the 22 partnerships were separate entities, they were all joined by LCA II. Therefore, allowing multi-entity apportionment was not an issue. Here, again, Ardmore and EJIW are separate business entities. Although they may operate in a unitary fashion, they remain legally separate.

Further, the result in *Preston* was dictated by the ITA and the Treasury regulations. Again, MCL 206.115 provides, "All business income . . . shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3." In *Preston*, the plaintiff's business income came from LCA II and was then apportioned by the apportionment factors. Also, Rule 206.12(16)(12), provides, "Distributive share items received by a partner are allocated or apportioned as follows: (a) Ordinary income is apportioned to Michigan by the partnership apportionment factors provided in . . . [MCL] 206.115 to 206.195." In *Preston*, the plaintiff was the partner, and his distributed share of income was received from LCA II and then apportioned by the partnership apportionment factors.

Unlike the plaintiff in *Preston*, the plaintiffs here receive business income from two separate businesses. Therefore, they must apportion at the entity level. As discussed above, allowing the plaintiffs to combine all their business income from separate entities and then apportion it based on the apportionment factors, or alternately requiring other similarly situated taxpayers to do so whether or not the result would be favorable to them, would raise due process concerns and cause the ITA to be applied inconsistently.

For these reasons, we hold that the court erred in granting summary disposition to plaintiffs and incorrectly allowed plaintiffs to combine their business income from separate entities under MCL 206.115.

Reversed.

/s/ Douglas B. Shapiro  
/s/ Henry William Saad  
/s/ Jane M. Beckering