SALT BUZZ HF

How Should the Net Worth Base be Calculated in Unitary Groups?

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Derek K. Heyman, PhD, JD, CPA
Attorney

Two recent cases from Michigan – *TCF National Bank v. Dept. of Treasury* (Nos. 344892 & 344906, Mich. App. 12/12/19) and *Comerica, Inc. v. Dept. of Treasury (*No. 344754, Mich. App. 4/16/20) exhibit the intricacies of calculating the net worth base for taxes on financial institutions. Both of these decisions involved the Michigan Business Tax ("MBT"), which included a franchise tax applicable between January 1, 2008 and December 31, 2011 to financial institutions doing business in Michigan. The *Comerica* decision also included a holding on the transferability of credits earned under the Single Business Tax ("SBT") in the context of a financial institution merger.

TCF

TCF was a consolidated decision resolving the appeals of both TCF National Bank ("TCF") and Flagstar Bancorp., Inc. ("Flagstar"), which involved the same issue and similar facts. TCF is a federally chartered national bank with Michigan branches, and is a wholly owned subsidiary of TCF Financial Corporation, a Delaware holding company headquartered in Minnesota. TCF filed its MBT return as the designated member of a 16-member unitary business group ("UBG") consisting of TCF Financial Corporation and its subsidiaries. Flagstar is itself headquartered in Michigan and is a holding company for Flagstar Bank as well as the designated member for the filing of a 13-member unitary return. Flagstar's UBG contained a three-year-old member that had been created from the equity of its parent.[1]

Both taxpayers had appealed decisions of the Court of Claims affirming the Department of Treasury's ("Department") Final Assessments. The appeals challenged the Department's method of calculating the "net capital" upon which the franchise tax was based. The Department's method, based on its interpretation of Mich. Comp. Laws ("MCL") 208.1265, consisted of identifying each of the UBG members' equity capital, subtracting from that the investments in other members of the UBG, and subtracting goodwill and government obligations. This left the net capital of each member, which was averaged over the most recent five tax years including the current tax year. If a member was in existence for less than five years, the average was based on the member's years in existence. The averaged net capital of the members was then added together to arrive at the UBG's net capital subject to tax.

Both TCF and Flagstar argued that this methodology of averaging each member of the UBG separately was inconsistent with the statute, which required that the UBG's net capital be averaged over the UBG's most recent five years of existence (both the TCF and Flagstar UBGs were over five years old but certain members had not been in existence for five years). As the Court of Appeals stated when summarizing Flagstar's argument, "one of its members, created wholly out of the equity of the parent, should not have been subject to a three-year average for its years in existence; rather it should have been subject to the UBG's five year average."

The Court of Appeals read MCL sections 208.1261(f), 208.1263, and 208.1265 together in order to determine the correct means of calculating average net equity and found that the taxpayers were correct.

To begin, the definition of "financial institution" found at MCL 208.1261(f) included (i) a list of institution types qualifying as financial institutions; (ii) such institutions' unitary subsidiaries that are not insurance companies; and (iii) "A unitary business group of [such] entities". For purposes of this ruling, the key part of this definition is that "financial institution" may refer to a UBG, not just to an individual legal entity. Thus, MCL 208.1263(1) imposed the franchise tax on "every financial institution with nexus in this state *** upon the tax base of the financial institution as determined under [MCL 208.1265] after allocation or apportionment to this state, at the rate of 0.235%" (emphasis added by the Court of Appeals). In the Court of Appeals' words, "[t]he legislature's use of the singular article 'the' plainly signifies that the tax applies to a singular tax base of a singular taxpayer." If a UBG files a return, therefore, the tax must be calculated on the UBG considered as a single taxpayer.

In light of its reading of MCL 208.1261(f) and MCL 208.1263, the Court of Appeals goes on to discuss the methodology set out in MCL 208.1265 for determining the tax base. The Court

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1 The Court of Appeals never states how many of TCF's subsidiaries were less than five years old. However, it is clear from the Court of Claims' discussion that at least one of TCF's subsidiaries must have been in existence fewer than five years, as it is the shorter averaging period used for some members that results in a higher average. *TCF National Bank v. Dep't of Treasury* (No. 16-000191-MT, Mich. Ct. of Claims 7/10/18), footnote 6.

of Appeals explains why the Department's method of calculating net capital in the context of a UBG is incorrect: "Read together, MCL 208.1261(f), MCL 208.1263, and MCL 208.1265 unambiguously indicate that the Legislature intended the term 'financial institution' to mean a UBG when a UBG taxpayer's franchise tax liability is at issue." With this meaning established, the Court of Appeals reads division (2) of MCL 208.1265, which begins, "[n]et capital shall be determined by adding the financial institution's net capital as of the close of the current tax year and the preceding 4 tax years and dividing the resulting sum by 5" as requiring that the group members' net capital be aggregated prior to the averaging step. The averaging is then performed once, over the full 5-year period or as many years as the UBG itself has been in existence, per the remaining language of MCL 208.1265(2) (omitted from the above quotation). Thus, the Department and the Court of Claims were both incorrect to read the statute as requiring the averaging be done prior to aggregating the net equity of the UBG; rather, the aggregating of the UBG's net equity comes before the averaging.

Comerica

In its *Comerica* decision, issued on April 16, the Michigan Court of Appeals again looked at the net equity calculation provisions of § 208.1265(2), as well as a tax credit assignment provision of the Single Business Tax ("SBT"). The wrinkle this time was that the petitioner, a bank holding corporation, converted one of its subsidiary financial corporations, a Michigan-chartered bank ("Comerica-Michigan") into a Texas banking association via the creation of a new entity, "Comerica-Texas," and the merger of Comerica-Michigan into that new entity. After the merger, which took place in 2007, Comerica-Michigan ceased to exist and all of its "rights, privileges, powers, franchises, and all property (real, personal, and mixed) as well as all debts, liabilities, and duties, vested in Comerica-Texas."

Upon audit of Comerica's tax year 2008 – 2011 MBT returns, the Department, similarly to what they had done in *TCF*, treated Comerica-Michigan and Comerica-Texas as separate entities with their own net capital. For tax year 2008, the Department included the net capital of Comerica-Michigan, averaged over 5 years and the net capital of Comerica-Texas, averaged over two years, and continued this pattern of averaging both entities' net capital and then adding them together throughout the audited years. [2] Comerica maintained that the Department had double-counted the net equity that was averaged for both entities and then accumulated at the UBG level. Comerica also challenged the disallowance of the credits.

Regarding the net equity issue, the Court of Appeals disagreed with the Department's attempt to distinguish *Comerica* from *TCF* on the basis that the earlier case had not involved the merger of two subsidiary banks. The court determined that the holding in TCF is general enough to apply when the UBG includes two subsidiaries that have merged. The averaging occurs only once, at the UBG level.

The credit issue turned on the SBT provision for one and only one assignment of a credit, codified at both MCL 208.38g(18) and MCL 208.39c(7) in the same language: " *** A partner, member, or shareholder that is an assignee shall not subsequently assign a credit or

2 The Department's calculation is clear in the decision of the Michigan Tax Tribunal (Docket No. 17-000150-TT), which decided against the Department on this issue.

any portion of a credit assigned under this subsection." As the parties had agreed that the subject credits had once been assigned prior to the merger of Comerica-Michigan and Comerica-Texas, the Department asserted that the credits could not again change hands as the result of the merger, because this would amount to a second assignment. Comerica's assertion that the second transfer was by operation of law, not by assignment, had been rejected by the Michigan Tax Tribunal (Docket No. 17-000150-TT), which held that a transfer by operation of law had not clearly occurred because the merger was not unintentional or involuntary and because the credits, being privileges, not property rights, could only be transferred by assignment.

The Court of Appeals rejected the Tribunal's reasoning on both fronts. First, there was clearly an operation of law because the transfer of credits took place when Comerica-Michigan merged into Comerica-Texas. The distinction between voluntary and involuntary transfers would rightly disallow a purchase of the credits themselves, but the merger, though voluntarily initiated, sets into force the terms of the statute under which the merger takes place. This constitutes an operation of law, as distinct from an assignment, and is not forbidden by the SBT statutes. The relevant merger statute, § 487.13703(1), is clear that "the title to all property, real, personal, and mixed, is transferred" to the surviving entity of the merger. But do the credits qualify as property? In the Court of Appeals' view, although the mere expectation of a government entitlement—such as a claim for a tax refund—may not constitute a cognizable property interest, certified tax credits do. Therefore, the tax credits, being property rights, transfer by operation of law upon the voluntary act of merging the entities.

Conclusion

These two cases, *TCF* and *Comerica*, exhibit some of the intricacies of state tax law that may be triggered by merger and reorganization activity and require careful consideration, particularly in the application of net worth taxes. Although these cases were decided under Michigan's now defunct SBT and MBT, current laws in many states, including Pennsylvania's Financial Institution Tax, Kentucky's Bank Franchise Tax, and Ohio's Financial Institutions Tax (whose tax base is the total Ohio equity capital of the consolidated group filing an FR Y-9 or a call report), may present unforeseen pitfalls in merger and reorganization situations that should be evaluated. These cases represent victories for the taxpayers, but not before a lengthy face-off with the Michigan Department of Treasury. Thus, taxpayers are advised to plan carefully, consult with a trusted tax advisor, and consider options to appeal when they have reason to be confident that the law is on their side.

If you would like to further discuss the *TCF* or *Comerica* cases or any other state and local tax matter, please contact Derek Heyman, Deb McGraw or any other ZHF professional.

ZAINO HALL & FARRIN LLC

ATTORNEYS AT LAW

WWW.ZHFTAXLAW.COM

614-326-1120
855-770-1120 (toll-free)

RON AMSTUTZ
(non-attorney professional)
614-782-1545(Direct)
330-347-3533 (Mobile)
ronamstutz@zhfconsulting.com

DAN DODD
614-782-1554 (Direct)
740-973-5930 (Mobile)
dandodd@zhfconsulting.com

STEPHEN K. HALL
614-349-4812 (Direct)
614-284-1253 (Mobile)
shall@zhftaxlaw.com

PHILLIP L. LAWLESS
(non-attorney professional)
614-349-4821 (Direct)
614-565-6098 (Mobile)
plawless@zhftaxlaw.com

BRAD W. TOMLINSON
(non-attorney professional)
614-349-4818 (Direct)
btomlinson@zhftaxlaw.com

JENNIFER R. TURNER
(non-attorney professional)
614-782-1642 (Direct)
502-594-9297 (Mobile)
jturner@zhftaxlaw.com

THOMAS M. ZAINO
614-349-4810 (Direct)
614-598-1596 (Mobile)
tzaino@zhftaxlaw.com

RICHARD S. BITONTE
(non-attorney professional)
614-782-1555 (Direct)
rbitonte@zhfconsulting.com

RICHARD C. FARRIN
614-349-4811 (Direct)
614-634-3130 (Mobile)
rfarrin@zhftaxlaw.com

DEREK K. HEYMAN
614-349-4814 (Direct)
(614) 353-0878 (Mobile)
dheyman@zhftaxlaw.com

DEBORA D. MCGRAW
614-349-4813 (Direct)
614-595-5560 (Mobile)
dmcgraw@zhftaxlaw.com

JOHN R. TRIPPIER
(non-attorney professional)
614-349-4815 (Direct)
614-203-4173 (Mobile)
jtrippier@zhftaxlaw.com

JASON W. WALKER
(non-attorney professional)
614-349-4817 (Direct)
916-533-1626 (Mobile)
jwalker@zhftaxlaw.com