

***Honigman v City of Detroit*ⁱ: Service Providers Owe City Income Tax in the City in Which Work is Done**

By: Wayne D. Roberts and Darren J. Burmania

On May 18, 2020, the Michigan Supreme Court decided the *Honigman* litigation to finally resolve a dispute over how legal services must be situated, or sourced, for purposes of calculating the law firm's City of Detroit income tax liability. In its decision, the Michigan Supreme Court held that services must be situated using an "origin" methodology to the city in which the work is performed or "done." The Supreme Court holding reversed the decision of the Michigan Court of Appeals and effectively reinstated the decision from the Michigan Tax Tribunal. Although the *Honigman* decision specifically dealt with the City of Detroit, it has widespread ramifications because all Michigan cities that impose an income tax levy such taxes pursuant to the Michigan Uniform City Income Tax Ordinance ("UCITO"). As a result, all city income taxes in Michigan are calculated using the statute in dispute in *Honigman*, MCL 141.623, to calculate the "revenue factor" that applies to the types of personal services at issue.

Background Facts

The City of Detroit reviewed Honigman's city income tax returns and issued city income tax assessments of approximately \$1.1 million against the Honigman law firm for tax years 2010-2014.ⁱⁱ These assessments became final in 2016 and Honigman appealed the assessments. The dispute focused on the statutory apportionment methodology used to situs revenues earned by the law firm from legal services provided to clients. The statute at issue sourced these legal service revenues to Detroit if the services were "rendered" in the City.

The method of sourcing service revenues is important because city income tax liabilities are calculated by multiplying the taxpayer's total income by an "apportionment" factor before multiplying the apportioned tax base by the city income tax rate. This type of formulary apportionment methodology is used to ensure that taxpayers are taxed only on the income that is properly attributed to the city at issue. Under the UCITO applicable in Detroit, taxable income is apportioned to Detroit using an equally-weighted, three-factor formula comprised of payroll, property, and revenue factors. The revenue factor is calculated by applying a fraction that is comprised of the taxpayer's revenue sourced to Detroit, divided by the taxpayer's total revenue earned everywhere.

Detroit Revenue Factor = Detroit Source Revenue/Total Revenue Earned Everywhere

The Michigan Tax Tribunal initially heard the appeal and ruled in favor of the City of Detroit. The Tax Tribunal concluded that, for purposes of the UCITO, services are rendered in the city if the work to provide the services is done, or performed, in the city. On appeal, the Michigan Court of Appeals reversed and held that services are rendered where the services are “delivered” to the client. In its decision, the Court of Appeals applied a market-based, destination sourcing methodology that is similar to the methodology used for sales of goods, and accepted the billing address as a proxy for delivery location.

The City of Detroit filed an application for leave to appeal with the Michigan Supreme Court, which was granted. The issue in dispute in the Supreme Court was the method of siting service revenue earned by the law firm’s attorneys. The City of Detroit took the position that service revenues must be situated based on the location where the work is being done, or performed, while the law firm argued that service revenues should be situated to the location the services are “delivered” based on the client’s billing address.ⁱⁱⁱ

The Michigan Supreme Court Decision

In a decision written by Justice Markman, and joined by Justices Zahra, Bernstein, and Cavanagh, the Court held that service revenue must be situated using an “origin” theory based on the location at which the work is performed.^{iv} The majority concluded that the Legislature intended to use this “origin” approach to situs service revenues. The majority also noted that this methodology is different from the methodology used to situs revenue from the sales of goods, which is based on destination – to the location at which the goods are delivered to the customer.

A key issue in the case was the fact that the UCITO used the terms “services performed” and “services rendered” within the statute with respect to the calculation of the city income tax liability. Under traditional canons of construction, the use of different terms creates a presumption that the Legislature intended the terms to have different meanings. However, both the majority and the concurring minority concluded that “services rendered” had a meaning similar to the term “services performed” for purposes of the city income tax, and each term indicated that services are sourced “in the city” if the work is performed, or done, in the city at issue.

In its decision, to establish a foundation for its analysis, the Court provided a review of methods used by states to situs both sales and service revenue for purposes of business income and franchise taxes. The Court also reviewed the history of the UCITO in connection with multi-state and Michigan tax law governing the sourcing of service revenue using both origin sourcing (e.g., the UCITO and the Michigan Single Business Tax^v), and market-based, destination sourcing (e.g., the Michigan Business Tax^{vi} and the Michigan Corporate Income Tax^{vii}).

Practical Implications

The *Honigman* decision confirms that service revenues must be sourced to the location where the work is done. While some commentators have predicted tax revenue windfalls for cities that impose income taxes, the ultimate effect on each city, and each service provider’s city income tax liability, will be largely fact-intensive.

For *Honigman*, the result was a dramatic increase in its Detroit city income tax liability because the firm had many lawyers working in the city to perform services for clients that were either located or receiving bills outside of the city of Detroit. However, other law firms may realize a different result. For example, for a law firm located in a suburb of Detroit that has 100% of its clients headquartered in Detroit, the *Honigman* decision will mean that the city income tax liability should approach \$0 (i.e., if all of the service work is done outside of the City of Detroit, then no revenue from Detroit

clients would be included in the revenue factor, and there likely would be no payroll or property in Detroit).

In addition, although the *Honigman* decision applies directly only to business income earned from providing services to clients, the decision's analysis reaffirms the fact that employee payroll is also situated to the employee's work location. These work-location-based rules affect both payroll factors for businesses and city income tax liabilities and withholding determinations for employees. In the current business climate, which includes stay-at-home orders and changes in the market that involve both mobile and remote work, businesses, service providers, and their clients are well-advised to review all of their city income tax compliance, withholding, and structural planning matters carefully.

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Please contact your Bodman Attorney if you have any questions about this Supreme Court decision. Bodman cannot respond to your questions or receive information from you without first clearing potential conflicts with other clients. Thank you for your patience and understanding.

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ⁱ *Honigman Miller Schwartz and Cohn LLP v City of Detroit*, Mich. Sup. Ct. Docket No. 157522 (May 18, 2020).

ⁱⁱ Tax years beginning after 2014 were not included in the assessments. Beginning in 2015, Detroit City Income Taxes are administered by the Michigan Department of Treasury.

ⁱⁱⁱ See *Honigman*, footnote 20 (The Court noted that, even if service revenue were to be sourced using a market-based, destination approach, the use of billing address was not a proper measure of delivery destination for services).

^{iv} The concurring opinion also joined in this holding, but did not agree with a portion of the decision that addressed the issue of the Legislature's use of different terms within the same Act.

^v Mich. Comp. Laws § 208.53 (service revenues sourced to Michigan based on where the work is done using a costs of performance approach).

^{vi} See Mich. Comp. Laws § 208.1305(2) (service revenues sourced to Michigan based on the location where the benefit of the service is received by the customer).

^{vii} See Mich. Comp. Laws § 206.665(2) (service revenues sourced to Michigan based on the location where the benefit of the service is received by the customer).