

Transitioning to the Michigan Corporate Income Tax



Out With the Old and In With the New

By Wayne D. Roberts

Effective January 1, 2012, Michigan no longer imposes a unique business tax. Both the Single Business Tax (SBT)¹ and the Michigan Business Tax (MBT)² have been repealed. On May 25, 2011, Governor Snyder signed sweeping tax changes into law that included enactment of the new Michigan Corporate Income Tax (CIT).³ The new CIT has been described as the “rebirth” of a corporate income tax in Michigan; a similar tax was imposed before 1975.⁴ The enactment of the CIT coupled with the repeal of the short-lived MBT constitutes the second comprehensive overhaul of the Michigan tax system in a four-year period.

Fast Facts:

The Michigan Corporate Income Tax (CIT) is simpler than any business tax that Michigan has imposed in more than 30 years.

It is estimated that 95,000 businesses in Michigan, many of which paid both the Single Business Tax (SBT) and the Michigan Business Tax (MBT), will no longer be subject to any business activity tax in Michigan.

In contrast to the MBT's multiple, complicated tax credit provisions, the CIT contains only one generally applicable credit: the small business credit.

Transitioning to the CIT

The unpopularity of Michigan's prior, one-of-a-kind business taxes (the SBT and the MBT) ultimately forced both to be repealed. In fact, the MBT was so unpopular that its repeal became a key campaign issue in Michigan's 2010 gubernatorial race. The laws signed by Governor Snyder in 2011 repealed the MBT for virtually all taxpayers but did not replace the MBT with another new business tax; instead, the 2011 legislation amended Michigan's existing Income Tax Act⁵ to extend Michigan's income tax to corporations and create new, separate taxes applicable to financial institutions and insurance companies.⁶ This article provides an overview of the new CIT, identifies key transition issues, and highlights certain practice and planning considerations for taxpayers and their advisors.

Overview of the CIT

The CIT is simpler than any business tax that Michigan has imposed in more than 30 years; it is a "flat" tax imposed at a rate of 6 percent.⁷ Administration is simplified because the new tax is subject to established procedures set forth in Michigan's Revenue Act.⁸ In reviewing the basics of the CIT, it is important to remember that while the Department of Treasury (the "Department") is preparing to administer this new, simpler tax, it also must admin-

ister four MBT tax years and deal with at least one open SBT tax year for many taxpayers. Concerning the CIT, key elements of the new tax that differentiate it from prior Michigan taxes include who is and isn't subject to the CIT, the CIT tax base, the expansive CIT nexus standard, and the CIT's nearly total lack of tax credits.

Definition of Taxpayer Under the CIT

The general CIT is a corporate income tax that applies only to persons who are taxable as "C" corporations under subchapter C of the Internal Revenue Code of 1986, as amended (the "Code"), and to "unitary business groups" of C corporations.⁹

Because the CIT applies only to C corporations, one key point to highlight is the large group of persons not subject to the CIT. It is estimated that 95,000 businesses in Michigan, many of which paid both SBT and MBT, will no longer be subject to any business activity tax in Michigan. These organizations include many sole proprietorships, partnerships, S corporations, and LLCs that have not elected or are ineligible to be taxed as C corporations. The income from such flow-through entities will continue to be taxed to their owners on a flow-through basis at Michigan's lower individual income tax rate.¹⁰ It is important to note that before 2012, flow-through entities were taxed at the entity level *and* the income that flowed through to their members or partners was

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again taxed at the individual level at Michigan's individual income tax rate. The CIT has effectively eliminated this double tax on business earnings from flow-through entities.

Formal Adoption of Federal Classification for Disregarded Entities: Putting an End to the *Kmart* Controversy

On December 27, 2011, PA 309 was signed into law to clarify that "a disregarded entity for federal tax purposes under the internal revenue code shall be classified as a disregarded entity for purposes of [the CIT Act]."¹¹ This clarification, which may seem simple, was made to avoid the kind of ambiguities and protracted litigation that culminated in the Michigan Court of Appeals decision in the SBT case *Kmart Michigan Prop Servs, LLC v Dep't of Treasury*.¹² To highlight the broad application and importance of this issue, a brief review of the *Kmart* decision follows.

In *Kmart*, the Michigan Court of Appeals determined that a federally disregarded LLC was a separate "person" under the SBT Act and, as such, was required to file a separate SBT return. This decision invalidated longstanding Department administrative guidance that had indicated that SBT classification rules conformed to federal classification under the check-the-box regulations. The *Kmart* decision created a great deal of controversy, and the Department determined that all disregarded LLCs would be required to file prior year SBT returns—even if the disregarded LLC had been included in its members' SBT return.¹³ This reversal of administrative position could have required hundreds of additional SBT returns to be filed despite the fact that there may not have been a single additional dollar of SBT owed by the disregarded entities that would be filing separate returns. The uprising over both *Kmart* and the Department's reaction to *Kmart* ultimately resulted in the legislature passing an amendment to the Michigan Revenue Act that was intended to mitigate the impact of the decision.¹⁴ Technically, despite enacting language indicating that the amendment "reinstates the law governing disregarded entities under the SBT in effect prior to *Kmart*,"¹⁵ the *Kmart* amendments did not amend the SBT Act and did not reverse the *Kmart* decision; this was not done because the SBT Act had been repealed. Instead, the *Kmart* "fix" involved amendments to the Revenue Act that expressly prohibit refund claims and tax assessments based on treating federally disregarded entities as separate taxpayers.

With respect to the MBT, a law was enacted to retroactively amend the MBT Act, effective January 1, 2008, to confirm that the MBT classification rules conform to federal classification under the check-the-box regulations.¹⁶ The MBT Act could be amended retroactively¹⁷ because it was still in effect when the clarifying amendment was signed into law. Taken together, these three legislative amendments appear to have put the *Kmart* controversy to rest.

Unitary Business Groups and Mandatory Combined Filing

The CIT incorporates mandatory combined filing for "unitary business groups."¹⁸ Unitary combined filing was introduced to Michigan under the MBT and generally has invalidated much of the separate company tax planning that was in place for tax years before 2008. A unitary business group generally will be required

to file a combined return in cases in which there is an affiliated group of corporations if:

- there is common ownership of more than 50 percent¹⁹; and
- there is an interrelationship between or among the businesses that creates centralized management, economies of scale, and functional integration.²⁰

Unitary business groups under the CIT include only C corporations and expressly exclude flow-through entities.²¹

CIT Tax Base

The CIT tax base generally will be based on a corporation's federal taxable income. Moreover, obtaining the federal taxable income amount often will be as easy as referring to the federal corporate income tax return, Form 1120, that is filed with the Internal Revenue Service.²² The basic structure of the CIT is as follows:²³

CIT	Tax Base	Rate	Surcharge	Eff. Rate	Apprmt.
Corporate income tax	Federal taxable income, as adjusted for CIT, apportioned to Michigan	6%	N/A No surcharge	6%	100% sales <u>MI sales</u> Total sales
Alternative small business tax	Adjusted business income	1.8%	N/A No surcharge	1.8%	100% sales <u>MI sales</u> Total sales

By comparison, the structure of the generally applicable MBT was as follows:

MBT	Tax Base	Rate	Surcharge	Eff. Rate	Apprmt.
Business income tax (BIT)	Federal taxable income, as adjusted for MBT, apportioned to Michigan	4.95%	21.99% \$6M cap	6.0385%	100% sales <u>MI sales</u> Total sales
Modified gross receipts tax (MGRT)	Gross receipts less "purchases from other firms," apportioned to Michigan	0.8%	21.99% \$6M cap	0.976%	100% sales <u>MI sales</u> Total sales
Alternative small business tax	Adjusted business income	1.8%	N/A No surcharge	1.8%	100% sales <u>MI sales</u> Total sales

For most taxpayers, there is no longer any Michigan tax with a gross receipts tax base. The small business tax provisions in Michigan remain similar to the small business tax that applied under the MBT. The principal difference for many small businesses under the new CIT will be that, because they are not C corporations, they are no longer subject to any separate Michigan business tax.

Apportionment Under the CIT

For a taxpayer with business activity only in Michigan, all income is allocated to Michigan and subject to the 6 percent CIT rate.²⁴ For a taxpayer with business activity in Michigan and at least one other state (or foreign country), the CIT is apportioned between or among the applicable states using a single factor apportionment method based solely on sales.²⁵ A taxpayer generally will compute its Michigan taxable income as follows:²⁶

$$\text{Federal Taxable Income (with Michigan Adjustments)} \times \frac{\text{Michigan Sales}}{\text{Total Sales}} = \text{Michigan Taxable Income}$$

The single-sales factor apportionment applies to the CIT without regard to potentially applicable multistate tax compact election provisions that existed before the enactment of the new legislation.²⁷ Concerning sourcing, all sales, including sales of tangible personal property, services, and intangible income, are sourced based on a market approach (i.e., generally sourced to the state in which the customer is located).²⁸

CIT Nexus and PL 86-272

Because the CIT is an income tax, it is subject to federal restrictions imposed under PL 86-272.²⁹ Under PL 86-272, an income tax generally cannot be imposed on a non-Michigan company if the company's sole activity in Michigan is solicitation of sales of tangible personal property.³⁰ The application of PL 86-272 should allow some non-Michigan companies, including some that paid both SBT and MBT, to avoid paying the Michigan CIT.

For a taxpayer with business activity that exceeds "mere solicitation" or involves more than the sale of tangible personal property, the nexus provisions contained in the CIT include references to broad economic nexus standards that represent both a continuation and an expansion of the economic nexus provisions included in the prior MBT. The broad CIT nexus standard is summarized in the table below:

Basis for Nexus	CIT Standard Applied
Physical Presence Nexus	The taxpayer has a physical presence in Michigan for more than one day during the tax year.
Economic Presence Nexus	The taxpayer: <ul style="list-style-type: none"> • actively solicits sales in Michigan; and • has gross receipts of \$350,000 or more sourced to Michigan.
Economic/Attributional Nexus	The taxpayer has an ownership interest or a beneficial interest in a flow-through entity that has substantial nexus in Michigan. ³¹

Economic nexus standards generally are inconsistent with the physical presence standard set forth in *Quill v North Dakota*,³² however, many states have adopted and litigated nexus standards

that rely on non-physical presence in recent years.³³ In light of these developments, non-Michigan businesses should understand the new CIT nexus provisions and exercise care to minimize their exposure to Michigan's CIT.

Tax Credits

In contrast to the MBT's multiple, complicated tax credit provisions, the CIT contains only one generally applicable tax credit: the small business credit. The small business credit is a carryover from both the SBT and MBT and retains the same general structure that has been applicable to Michigan small businesses for decades. The credit applies to a "small business," which is defined as a business that has:

- gross receipts of not more than \$20,000,000;
- business income of not more than \$1,300,000; and
- individual shareholder/officer compensation of not more than \$180,000.³⁴

This is a conjunctive test and, therefore, a taxpayer must satisfy all three requirements to qualify for the credit. For a qualifying taxpayer, the amount of the small business credit will be a calculated amount equal to the amount needed to reduce the taxpayer's total CIT liability to equal 1.8 percent of "adjusted business income."³⁵ The effect of the small business credit is the creation of an alternative 1.8 percent income tax system for small businesses. In general, this should be nothing new to Michigan businesses because this is the way small businesses have been taxed in Michigan for more than 30 years.

Effective January 1, 2012, unless a taxpayer elects to calculate its tax liability under the MBT, there generally are no other tax credits. This means that all the targeted tax credits designed to benefit manufacturing companies in Michigan are no longer available. The eliminated credits include the compensation credit, which reportedly had been a source of meaningful tax relief to Michigan-based manufacturing companies, and the Investment Tax Credit.

Certificated Tax Credits and the Alternative MBT Election

Notwithstanding the full repeal of the MBT, taxpayers with "certificated credits" that were not fully paid or received by January 1, 2012, could elect to retain the credits by continuing to pay the MBT in lieu of the CIT.³⁶ The MBT election must be made for the taxpayer's first tax year following December 31, 2011—the 2012 calendar year for most taxpayers—and can be made in subsequent years in which the certificated credits or any unused carryforwards can be claimed.³⁷ This elective provision applies to existing MBT certificated credits such as MEGA, brownfield redevelopment, renaissance zones, film production, battery, and other specified credits.³⁸

In exchange for retaining their certificated credits, taxpayers making the MBT election must pay a tax based on the greater of their MBT liability or a modified version of the liability they would have paid if they had filed under the CIT.³⁹ In cases in which

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the tax calculation results in a negative amount, that amount (subject to statutory limitations) generally will be refunded to the taxpayer.⁴⁰ Once certificated credits have been exhausted, the taxpayer is no longer eligible to file under the MBT.⁴¹

The CIT Withholding Regime

The CIT ushered in an entirely new withholding regime in Michigan. The withholding structure applies to flow-through entities that have non-Michigan corporate or flow-through entity members.⁴² For a flow-through entity that has nexus in Michigan, the entity must withhold Michigan CIT equal to 6 percent of the distributive share of income attributable to the non-Michigan member.⁴³ For a structure that includes more than one level of flow-through entities, a credit is allowed for withholding at lower tiers to reduce the exposure to multiple withholdings on the same income.⁴⁴ Importantly, CIT withholding is based on “distributive share” and may bear no relationship to actual distributions. As a result, if there are no distributions in a year in which there is income earned, there may be a withholding obligation in the absence of any cash available to pay the withholding. Flow-through entity operating agreements may need to be revised to allow for actual or deemed distributions to facilitate compliance with the CIT’s new entity-level withholding requirements.

This type of withholding requirement can prove to be very burdensome, especially in cases involving multiple tiers of flow-through entity or corporate ownership. The Department is expected to publish guidance to address some of the ambiguities in the area of withholding.

Planning Under the CIT

Tax planning under the CIT is very different from planning for both the MBT and SBT. The most basic differences are that the

CIT is a “unitary” tax (so separate entity planning is limited), and the CIT applies only to C corporations. Concerning the latter difference, many would offer the following simplistic advice: (1) do not organize a business as a C corporation; and (2) if the current business is structured as a C corporation, convert the existing business to a different form of entity. These recommendations may be accurate in many instances; however, planning for the CIT in all but the very simplest cases requires thoughtful and comprehensive analysis. Rash decisions can have negative consequences in both the short and long term.

With respect to creating a new business as an entity other than a C corporation, there are many tax and non-tax considerations that need to be factored into the analysis. For example, if a start-up business is likely to realize little or no income during startup and will be postured for a public offering, the C corporation structure might be preferable and offer no CIT disadvantage. Similarly, for a professional corporation that “bonuses” out all of its income to service-provider shareholders, there may be little or no exposure to CIT liabilities. In the end, the facts and circumstances of each case must be evaluated to ensure that the appropriate entity is chosen.

The general proposition that an existing C corporation should be converted to another form of entity requires a more detailed analysis that is beyond the scope of this article. But generally, when a C corporation structure is eliminated, there will be some type of liquidation or deemed liquidation of C corporation assets. The liquidation of C corporation assets typically results in entity-level gain. There also can be actual or deemed dividends. The total cost of eliminating a C corporation structure should be evaluated carefully before taking such a drastic step in an effort to avoid a 6 percent (or possibly 1.8 percent) income tax. C corporation conversions can take multiple forms including liquidation, merger, and reorganization, and all aspects of any proposed restructuring should be thoroughly analyzed before being implemented.

Conclusion

The enactment of the CIT and repeal of the MBT yield a greatly simplified business tax structure in Michigan. Several complexities remain, however, including unitary combined reporting, expanded nexus standards, new withholding requirements, and the elective provisions available to taxpayers with MBT certificated credits. One additional issue that has become clear from initial experience with the new tax structure is that, while the basic CIT is simpler than the prior MBT, the CIT lacks many of the provisions that were included in the MBT in an effort to benefit Michigan manufacturing and target businesses based outside of Michigan for additional taxes. Moreover, while both taxpayers and the Department are adjusting to the new tax regime, there will continue to be ongoing audits, appeals, and litigation involving both the prior SBT and MBT, which will require attention for many years to come. ■



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FOOTNOTES

1. The SBT became effective January 1, 1976, and was repealed effective December 31, 2007.
2. See 2007 PA 36; MCL 208.1101. The MBT, which replaced the SBT, was in effect through the end of 2011. The MBT was a multifaceted tax that generally imposed tax on business activity in Michigan through both a business income tax (BIT) at 4.95 percent and a modified gross receipts tax (MGRT) at 0.8 percent. Absent a specific election, discussed *infra*, the MBT was repealed in full, effective for business activity after 2011. See also Roberts & Gell, eds, *Practical Guide to the Michigan Business Tax* (Chicago: CCH, 2010) (detailing the MBT).
3. 2011 PA 38.
4. *Id.* For a comprehensive review of the CIT as originally enacted, see Roberts & Gell, *Rebirth of the Michigan Corporate Income Tax*, 60 State Tax Notes 833 (2011).
5. MCL 206.1 through 206.532.
6. The taxation of financial institutions and insurance companies under the CIT is very similar to how such taxpayers were taxed under both the MBT and the SBT; these taxes are not the subject of this article. See 2011 PA 38. The CIT bills also made several changes to existing personal income tax provisions. This article addresses only the generally applicable new provisions for the corporate income tax.
7. Act 38, § 623(1). Businesses with tax liabilities less than \$100 or with apportioned gross receipts of less than \$350,000 will not be required to file a return. See Act 38, § 685(1).
8. See MCL 205.1 *et seq.*
9. Act 38, § 611(5). The CIT also imposes special taxes applicable to insurance companies and financial institutions.
10. Act 38, § 511(g) and (h). The individual income tax rate is 4.35 percent before January 1, 2013, and 4.25 percent beginning on January 1, 2013.
11. MCL 206.699.
12. *Kmart Michigan Prop Servs, LLC v Dep't of Treasury*, 283 Mich App 647; 770 NW2d 915 (2009).
13. See Dep't of Treasury, *Rescinded: Notice to Taxpayers Regarding Kmart Michigan Property Services LLC v Dep't of Treasury, the Single Business Tax, RAB 1999-9*, and *RAB 2000-5*, available at <http://www.michigan.gov/documents/taxes/Kmart_Notice_Retroactive_Application_Amended>Returns_1_310402_7.pdf> (accessed June 12, 2012).
14. 2010 PA 38; see also Dep't of Treasury Notice, n 13 *supra*.
15. Dep't of Treasury Notice, n 13 *supra*.
16. 2011 PA 194.
17. Even if retroactive amendments are possible, they remain subject to limitations imposed under Constitutional Due Process requirements. See, e.g., *United States v Carlton*, 512 US 26; 114 S Ct 2018; 129 L Ed 2d 22 (1994).
18. Act 38, § 691.
19. *Id.* at § 611(6).
20. See *Meadwestvaco v Illinois*, 553 US 16; 128 S Ct 1498; 170 L Ed 2d 404 (2008) (confirming that the test to determine whether a unitary business exists requires an analysis of centralized management, economies of scale, and functional integration); see also Dep't of Treasury, *Frequently Asked Questions: Corporate Income Tax* <<http://www.michigan.gov/taxes/0,4676,7238-59682-276552-F,00.html>> (accessed June 12, 2012).
21. Act 38, § 611(6); see Dep't of Treasury, n 20 *supra*.
22. There can be instances in which federal taxable income might not be equal to the amount reported in a federal Form 1120, but the legal analysis associated with such instances is beyond the scope of this article.
23. There also is a separate 1.25 percent premium tax applicable to insurance companies and a .29 percent franchise tax applicable to financial institutions. See Act 38, § 635(2) and § 653(1).
24. Act 38, § 661(2).
25. *Id.*
26. See *id.* In addition, apportionment of business income attributable to partners, members, and shareholders of flow-through entities also is based on a single-sales-factor apportionment method. The equally weighted three-factor approach previously used under the Michigan individual income tax has been eliminated. Individual business income apportionment and sourcing provisions differ in several ways from apportionment and sourcing provisions applicable to corporations. For example, although individuals now use single factor sales apportionment, there is potential for throwback sales for individuals; there are also other technical differences between the apportionment sourcing provisions that apply to individuals and corporations.
27. Act 38, § 663(3). Whether elections are available under the MBT for years before 2012 currently is being litigated. See *IBM v Dep't of Treasury*, Mich Ct App, Docket No. 306618.
28. Act 38, § 110.
29. 15 USC 381 through 384.
30. Assuming that the company is engaged in the sale of tangible personal property and is not a member of a unitary group.
31. Act 38, § 621(1).
32. *Quill v North Dakota*, 504 US 298; 112 S Ct 1904; 119 L Ed 2d 91 (1992).
33. See generally *Tax Comm'r of West Virginia v MBNA America Bank*, 220 W Va S Ct 163; 640 SE2d 226 (2006); *Lanco, Inc v Director of Taxation*, 379 N.J Super 562; 879 A2d 1234 (2005); *A&F Trademark, Inc v North Carolina*, 167 NC App 150; 605 SE2d 187 (2004).
34. Act 38, § 671(1).
35. *Id.* at § 671(4).
36. *Id.* at § 680(1).
37. *Id.* at § 680(2).
38. There also is a limited election available by which a taxpayer may elect to obtain a refund of 90 percent of the face value of certain brownfield and historic preservation credits.
39. 2011 PA 39, § 500(4). Once the MBT election is made, the electing taxpayer becomes fully subject to the MBT, including all MBT credits; therefore, an electing taxpayer could be calculating an MBT liability under the now-repealed MBT Act for many years.
40. Act 39, § 500(5).
41. *Id.* at § 500(3).
42. Act 38, § 703(4). This new CIT withholding requirement, which applies to flow-through entities with non-resident corporate or flow-through entity members, is in addition to the continuation of the *individual income tax* withholding requirement that applies to flow-through entities with non-resident *individual* members. See MCL 206.703(3).
43. Act 38, § 703(4).
44. *Id.* at § 703(5).