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Michigan Business Tax Unitary Business Group Control Test

Approved:

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RAB 2008-DRAFT

Under the Michigan Business Tax ("MBT"), a unitary business group is two or more persons that satisfy both a *control test* and one of two *relationship tests*.¹ A unitary business group is a single taxpayer under the MBT and must file a combined return.² Foreign persons and foreign operating entities cannot be included in a unitary business group.

This Revenue Administrative Bulletin ("RAB") describes the *control test* used in MCL 208.1117(6). If a group of entities satisfies the control test, that group of entities will constitute a unitary business group if that same group also satisfies one of two relationship tests. This RAB does not define or describe either of the relationship tests.

ISSUES

- I. How is a unitary business group defined under the MBT?
- II. What is the control test under the MBT?
- III. What are controlled groups of entities?
- IV. How do voting agreements affect the control test?

¹ MCL 08.1117(6).

² MCL 208.1117(5), 208.1511.

- V. How is control determined for nonstock nonprofit organizations?
- VI. How is a unitary business group determined if one entity is a member of more than one controlled groups of entities?
- VII. What is "indirect" ownership?
- VIII. How is the control test applied to foreign persons?
- IX. When is this RAB effective?

CONCLUSIONS

I. UNITARY BUSINESS GROUP DEFINED

Under the MBT, a unitary business group is defined as:

a group of United States persons, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.³

A group of U.S. persons must meet both a control test and one of two relationship tests before that group will be a unitary business group.

II. CONTROL TEST DEFINED

The control test is satisfied when one person owns or controls, directly or indirectly, more than 50% of the ownership interests with voting or comparable rights of the other person or persons.

A person owns or controls more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of another persons if that person owns or controls (1) more than 50% of the total combined voting power of all ownership interests with voting (or comparable) rights *or* (2) more than 50% of the total value of all ownership interests with voting (or comparable) rights. "Ownership interest with voting rights" includes all classes of stock in a corporation entitled to vote that possess the power to elect the membership of the board of directors of the corporation. "Ownership interests that confer comparable rights to voting rights" includes instruments, contracts, agreements, or other

³ MCL 208.1117(6).

authority demonstrating an ownership interest in that entity that confers power in the owner to vote in the selection of the management of that entity.

III. CONTROLLED GROUPS OF ENTITIES

A person owns or controls more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of another persons if that person owns or controls (1) more than 50% of the total combined voting power of all ownership interests with voting (or comparable) rights *or* (2) more than 50% of the total value of all ownership interests with voting (or comparable) rights. Entities that satisfy the MBT control test constitute "controlled groups of entities." Controlled groups of entities are described below.

Parent-Subsidiary Controlled Group of Entities. A parent-subsidiary controlled group of entities satisfies the control test. A parent-subsidiary controlled group of entities means any group of one or more chains of entities connected through ownership with a common parent if (1) the common parent directly or indirectly owns more than 50% of the ownership interests with voting or comparable rights of at least one other entity, and (2) more than 50% of the ownership interests with voting or comparable rights of each entity other than the common parent is owned directly or indirectly by one or more of the other entities.

Example 1. Corporation A owns 51% of Corporation B, which owns 51% of Corporation C, which owns 51% of Corporation D. The common parent owns more than 50% of the stock in at least one other entity (Corporation B), and more than 50% of the stock of each entity other than the common parent is owned by at least one other entity in the chain. Corporations A, B, C, and D are part of a parent-subsidiary controlled group of entities and satisfy the control test for unitary business groups.

Brother-Sister Controlled Group of Entities. A brother-sister group of entities may also satisfy the control test. A brother-sister controlled group of entities means two or more entities connected through common ownership where one such entity indirectly owns more than 50% of the ownership interests with voting or comparable rights of one or more of the other sibling entities.

Example 2. An individual owns 51% each of a pair of limited liability companies taxed as partnerships – One LLC and Two LLC. Under Section VII of this RAB, One LLC indirectly owns 51% of Two LLC. One LLC and Two LLC constitute a brother-sister controlled group of entities and meet the control test for unitary business groups.

Example 3. Two unrelated individuals each own 50% of Corporation H and Corporation I. Under Section VII of this RAB, Corporation H indirectly owns 100% of Corporation I. Corporation H and Corporation I constitute a brother-sister controlled group of entities and meet the control test for unitary business groups.

Combined Controlled Group of Entities. A combined controlled group of entities satisfies the control test. A combined controlled group of entities means three or more entities each of which is a member of a parent-subsiary controlled group of entities or brother-sister controlled group of entities and one of which is a common parent entity of a parent-subsiary controlled group of entities and also is included in a brother-sister controlled group of entities.

Example 4. An individual owns 51% each of a pair of corporations – Corporations L and M. Corporation L owns 51% of Corporation N, which owns 51% of Corporation O. Corporation L is the common parent of the L, N, and O parent-subsiary controlled group of entities and is also a member of the L and M brother-sister controlled group of entities. Corporations L, M, N, and O are members of a combined controlled group of entities and meet the control test for unitary business groups.

Excluded Ownership Interests. For purposes of determining ownership or control under the control test, the Department will apply IRC 1563(c) to exclude certain ownership interests from determination of ownership and control, except that the Department will apply IRC 1563 to all forms of ownership interests and not just corporate stock.

Example 5. Corporation X owns 50% of Partnership Y. The remainder of Partnership Y is owned by an individual that is also a principal stockholder under IRC 1563 of Corporation X. The ownership interests of the individual are treated as excluded ownership interests under IRC 1563(c) as applied to the MBT. For purposes of the control test for unitary business groups, Corporation X owns 100% of Partnership Y.

IV. VOTING AGREEMENTS

For purposes of this RAB, in determining whether the ownership interests owned by a person possess voting (or comparable) rights, the Department shall consider the facts and circumstances of each case. Ownership interests will generally be considered as possessing the voting rights accorded to such interests by statute, organization documents filed with the state, by-laws, certificates, agreements, or other authority. However, if there is any agreement – express or implied – that an owner will not vote his or her interests in an entity, the formal voting rights possessed by his or her interest may be disregarded in determining the percentage of ownership interests with voting rights owned by the other owners of the entity, if the result is that the entity satisfies the control test. Similarly, if an owner agrees to vote his or her ownership interests in the manner specified by another owner of the entity, the ownership interests with voting rights owned by the first owner may be considered to be owned by the other owner if the result is that the entity satisfies the control test. If an owners transfers voting power by proxy, voting trust, agreement, or similar device, and that transfer is revocable by the transferor, then the transferor shall be considered to be the owner of any ownership interest with voting rights otherwise transferred.

V. NONSTOCK NONPROFIT ORGANIZATIONS

For entities without stock or other forms of ownership interests, such as nonstock nonprofit organizations, a parent entity controls more than 50% of the ownership interests with voting or comparable rights of the nonstock nonprofit organization if more than 50% of the directors or trustees of that organization are either representatives of or controlled by the parent organization.

VI. ENTITY IN MORE THAN ONE CONTROLLED GROUP OF ENTITIES

If, under this RAB, an entity is a member of more than one controlled group of entities, the entity shall be treated as a member of the controlled group with respect to which it satisfies the relationship test under MCL 208.1117. If the entity satisfies the relationship test with more than one of those groups, it shall elect to be treated as a member of only one of the controlled groups in question. This election shall remain in effect until the unitary relationship between the entity and the rest of the members of its elected controlled group is discontinued, or until revoked with the approval of the Michigan Department of Treasury.

Similarly, if the application of this RAB results in a group of entities that comprise two or more overlapping controlled group of entities, but not one single controlled group of entities, the unitary business group shall be that controlled group of entities that satisfies the relationship test under MCL 208.1117. If more than one controlled group of entities satisfies the relationship test, the members shall elect the controlled group of entities that will file as a unitary business group. This election shall remain in effect until the unitary relationship between the entity and the rest of the members of its elected controlled group is discontinued, or until revoked with the approval of the Michigan Department of Treasury.

Example 6. Individual A owns a 75% capital interest in Partnerships X and Y, and 50% of the stock in Corporations L and M. The remaining 50% of L and M are owned by individuals B and C respectively. Individuals A, B, and C are unrelated. Under this RAB (including the indirect ownership principles discussed in Section VII), X, Y, and L comprise a brother-sister controlled group of entities. X, Y, and M also comprise a brother-sister controlled group of entities. However, X, Y, M, and L do not comprise a single controlled group of entities (since either L or M is the indirect owner of X and Y, but neither L nor M owns the other). The unitary business group in this case will be that controlled group of entities that satisfies the relationship test. If both controlled groups of entities satisfy the relationship test, then the members must select one of such controlled groups of entities to file as a unitary business group.

VII. INDIRECT OWNERSHIP

Under MCL 208.1117, ownership and control includes indirect ownership and control. Indirect ownership includes ownership through attribution. Except as noted below, an ownership interest is indirectly owned by a person when that person constructively owns such an interest.

(A) Family. An individual constructively owns the ownership interests owned, directly or indirectly, by any of the following:

- (1) His or her spouse (other than a spouse who is legally separated from the individual under a decree of divorce or a decree of separate maintenance).
- (2) Children, including legally adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.

Example 7. Brother owns 100% of Corporation B. Brother's sibling, Sister, owns 100% of Corporation S. Brother and Sister's parents are both living. Brother and Sister are 21 or older. Corporation B and Corporation S do not meet the control test for unitary business groups since, under (A)(2), there is no attribution from adult children to parents.

(B) Attribution from Partnerships, Corporations, and Trusts and Estates.

(1) **Partnerships.** Ownership interests owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5% or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever is greater.

(2) **Corporations.** If 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the ownership interests owned, directly or indirectly, by or for such corporation, in that proportion to which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(3) **Trusts and Estates.**

(a) Ownership interests owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary who has an actuarial interest of 5% or more in such ownership interests, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary.

(b) Ownership interests owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J of the IRC (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(c) This paragraph shall not apply to ownership interests owned by any employees' trust described in IRC 401(a) that is exempt from federal income tax under IRC 501(a).

(C) Attribution to Partnerships, Corporations, and Trusts and Estates.

(1) **Partnerships.** Ownership interests owned, directly or indirectly, by or for a partner shall be considered as owned by the partnership.

(2) **Corporations.** If 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the ownership interests owned, directly or indirectly, by or for such person.

(3) **Trusts and Estates.**

(a) Ownership interests owned, directly or indirectly, by or for a beneficiary of an estate shall be considered as owned by the estate.

(b) Ownership interests owned directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in IRC 401(a) and exempt from federal income tax under IRC 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this subsection, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5% or less of the value of the trust property.

(c) Ownership interests owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J of the IRC (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

(D) Options. If any person has an option to acquire any ownership interest in an organization, such interest shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such interest.

(E) Operating Principle.

(1) **In General.** Except as provided in subparagraphs (2) below, ownership interests constructively owned by a person by reason of the application of paragraphs (A), (B), (C), or (D) above, shall, for purposes of applying paragraphs (A), (B), (C), or (D), be considered as actually owned by such person.

(2) **Partnerships, Corporations, and Trusts and Estates.** Ownership interests constructively owned by a partnership, corporation, estate, or trust by reason of the application of paragraph (C) shall not be considered as owned by it for purposes of applying paragraph (B) in order to make another the constructive owner of such ownership interests.

(3) **Precedence of Option Principle.** For purposes of this paragraph, if an ownership interest may be considered as owned by a person under paragraph (A) or (D), it shall be considered as owned under paragraph (D).

(4) **Ownership by 2 or More Persons.** If an ownership interest is owned by two or more persons, such an interest shall be considered as owned by the person whose ownership of such an interest results in the entity being a member of a controlled group of entities. If by reason of the preceding sentence, an entity would (but for this sentence) become a member of two controlled groups, it shall be treated as a member of one controlled group.

(5) **S Corporations.** For purposes of this subsection, an S Corporation shall be treated as a partnership and any shareholder of the S Corporation shall be treated as a partner of such partnership. The preceding sentence shall not apply for purposes of determining whether stock in the S corporation is constructively owned by any person.

VIII. HOW IS THE CONTROL TEST APPLIED TO FOREIGN PERSONS?

Unitary business groups under the MBT are limited to U.S. persons other than foreign operating entities.⁴ Foreign persons are excluded from unitary business groups.⁵ However, the indirect ownership rules described above apply, regardless of whether foreign persons are includable in a unitary business group. That is, attribution of ownership interests can occur to, from, or through a foreign person; foreign persons do not cut off control.

Example 8. ForeignCo, a foreign corporation, owns 100% of Corporation Q and Corporation R, both U.S. persons. As a foreign person, ForeignCo cannot be a member of unitary business group. However, under this RAB, Corporation Q is the indirect owner – through ForeignCo – of 100% of Corporation R, and *vice versa*. Corporation Q and Corporation R meet the control test for unitary business groups.

A foreign person within a controlled group of entities that would otherwise satisfy the control test does not cut off the entities under the foreign entity from the unitary business group so long as the control and relationship tests are satisfied. For example, if Corporation C in Example 1 was a foreign person, Corporations A, B, and D would comprise the unitary business group. Corporation C is still used to determine ownership and control, but is excluded from the unitary business group due to MCL 208.1117.

⁴ MCL 208.1117(6).

⁵ MCL 208.1117(6).

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In addition, while the MBT generally follows the federal check-the-box regulations, the federal check-the-box regulations do not convert a "United States person" into a foreign entity or a foreign entity into a "United States person."⁶ For purposes of determining the membership of a unitary business group, the definition of "unitary business group" controls. Thus, foreign entities – or foreign operating entities – are excluded from unitary business groups even if that entity owns a domestic single member limited liability company disregarded for federal tax purposes. The domestic disregarded entity and foreign parent will file separately – the domestic subsidiary as part of the unitary business group and the foreign entity, or foreign operating entity, as a separate taxpayer.

Example 9. Corporation V, a domestic corporation, owns 80% of ForeignCo, a foreign corporation, which is the single member of Domestic LLC, a disregarded domestic entity. Corporation V and Domestic LLC meet the control test for unitary business groups. ForeignCo must be excluded from the unitary business group since it is a foreign person. If ForeignCo has nexus with Michigan, it must file a return separate from the combined return filed Corporation V and Domestic LLC (assuming those two entities also satisfy the relationship test).

Similarly, foreign entities or foreign operating entities are also excluded if that entity is the disregarded entity of a domestic entity included in a unitary business group. In that case, the foreign entity must file a separate return.

IX. WHEN IS THIS RAB EFFECTIVE?

This RAB and the control tests for unitary business groups described herein are effective January 1, 2009.

⁶ See, e.g., Treas. Reg. 301-7701-5.