By Steven E. Grob

Michigan Taxation of Pass-Through Entities

In recent years, there has been a proliferation of entities taxed as "pass-through" entities for federal income tax purposes. This article describes how such entities are treated for various Michigan taxes. Many of these Michigan tax consequences are positions expressed by the Michigan Department of Treasury (Department) in several Revenue Administrative Bulletins (RABs). There is no consistent treatment of pass-through entities for the Michigan taxes. In some cases the federal treatment is followed, and in other cases the entity is treated as a separate taxpayer or given special treatment.

Types of Federal Pass-Through Entities

The more common types of federal income tax pass-through entities that will be examined are:

- Multiple member limited liability company (MMLLC)
- Single member limited liability company (SMLLC)
- Subchapter S corporation (S Corp)
- Qualified subchapter S subsidiary (QSUB)
- General partnership (GP)
- Limited partnership (LP)
- Limited liability partnership (LLP)

For federal income tax purposes, two of these entities, the SMLLC and the QSUB, are technically not considered pass-through entities but are instead disregarded entities treated as if their assets were directly owned by the single member or single shareholder of such entity.

Types of Michigan Taxes Considered

Part I of this article will discuss single business tax (SBT). Part II will discuss the other Michigan taxes.

The various types of pass-through entities will be examined within the discussion of each tax.

Single Business Tax

The SBT is a quasi-value added tax that is generally imposed on all types of persons or entities having business activity (a broadly defined term) within Michigan.[1] The computation of the SBT generally begins with federal taxable income, which is then modified by a number of additions (such as interest expense, depreciation expense, most compensation expense, and most royalty expense) and subtractions (such as interest and dividend income, and royalty income) to arrive at the adjusted tax base. There are also special rules that apply, such as a limitation on the amount of the compensation add back, and an alternate method of paying tax on essentially 50 percent of gross receipts. An investment tax credit is allowed for a portion of the cost of qualifying property acquisitions. Taxpayers doing business both in Michigan and in another state or states must apportion their tax base using a three-factor formula with the following weighting of each factor: sales—90 percent; property—5 percent; and payroll—5 percent.

Comparison to Federal Treatment

The SBT is generally applied in the same manner to an MMLLC, an S Corp, a GP, an LP, and an LLP. Some variances are described below. This entity level taxation of a pass-through entity can be confusing to persons unfamiliar with the SBT who assume that it is similar to an income tax, which most states do not apply to a pass-through entity (the SBT has been judicially determined not to be an income tax). SBT does not apply to an SMLLC[2] (unless it elects corporate status) or a QSUB,[3] which are treated for SBT purposes as disregarded entities, similar to federal income tax treatment. Michigan SBT follows the federal "check the box" rules for unincorporated entities (such as a limited liability company or a partnership) that can file a federal election to be taxed as a corporation. No separate entity classification election is made with Michigan.[4]

In the case of an SMLLC, whatever treatment is effective for federal purposes will be followed for SBT purposes. This allows planning opportunities in situations where part of the business activity could be conducted in an SMLLC. If the SMLLC does not "check the box" to be treated as a corporation, it will be ignored and treated as if its assets were owned directly by its single member. This choice can dramatically impact nexus and apportionment considerations of the member.

For example, if a non-Michigan business forms or acquires an SMLLC taxed as a disregarded entity that has Michigan business activity, the member will become subject to Michigan SBT jurisdiction. The apportionment percentage is determined using the property, payroll, and sales of the combined entities (inter-entity sales are disregarded in the sales factor). Alternatively, if a federal check-the-box election is made, the SMLLC will be taxed separately in Michigan and its member will generally not be subject to Michigan tax jurisdiction.

Under Federal Treasury Regulation Section 301.7701-3, any unincorporated entity (such as a partnership or LLC) having two or more

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members may elect to be taxed as a corporation or by default it will be taxed as a partnership. For purposes of the SBT statutory exemption and small business credit, a member of an MMLLC is treated as a partner only if the MMLLC is taxed as a partnership.

There are several other variances in the SBT treatment of pass-through entities, including the following:

- An unincorporated entity and an S Corp qualify for the unincorporated/S Corporation tax credit that ranges (depending upon the level of business income) from 10 percent to 20 percent of the SBT liability. Such credit is available to an SMLLC regardless of whether a check-the-box election is made, but it is not available to a QSUB.
- If an LLC or other unincorporated entity elects to be taxed as a corporation, its members will be considered shareholders for purposes of the statutory exemption. However, a member is *not* considered a shareholder for purposes of the small business credit because the SBT Act specifically defines "shareholder" as an owner of stock for purposes of computing the credit.
- For all entities taxed as partnerships, the computation of eligibility for the small business credit or alternate tax is affected by each partner's distributive share of income. For purposes of computing the statutory exemption and the small business credit, a member of an LLC is treated as a partner *if* the LLC is taxed as a partnership.

Capital Acquisition Deduction and Investment Tax Credit

Until 2000, Michigan allowed SBT taxpayers to claim a capital acquisition deduction (CAD) equal to the cost of qualifying property in the year the cost of such property was incurred. Effective for tax years beginning on or after January 1, 2000, the CAD was repealed and replaced with an investment tax credit (ITC). Upon the disposition of the property (and certain other events), previously allowed CAD and ITC is recaptured. The department's administrative position is that various types of federally tax-free restructurings will not trigger CAD or ITC recapture.[5] Examples of this include:

- A contribution of property to an LLC or a partnership that is federally tax-free under Section 751 of the Internal Revenue Code (code).
- A contribution of property to an S corporation that is federally tax-free under Section 351 of the code.
- The distribution of assets from a partnership to its partners in liquidation of their interests where the distributee partners together own at least 80 percent of the distributed assets and they use such assets in the conduct of business activity.
- The liquidation of a wholly owned subsidiary corporation into its parent corporation that is federally tax-free under Section 332 of the code. (This is applicable when a QSUB election is made).

With regard to the consequences of a termination under Section 708(b) of the code of an entity taxed as a partnership, there has apparently been a recent change in the department's position. The old position was expressed prior to an amendment of the Federal Treasury Regulations under Section 708. Such position stated that there was no CAD recapture upon the liquidation of a partnership interest with no sale or exchange of property, providing the partnership is considered as continuing under Section 708(b) of the code.[6] If the partnership terminated under Section 708(b), there was CAD recapture. A department representative has said that because of the revision to the Federal Treasury Regulations under Section 708, the department will no longer treat a Section 708(b) termination as an event causing CAD or ITC recapture.[7]

Financial Organization

A recent RAB[8] defines when an entity will be treated as a "financial organization" for SBT purposes. The tax base of a financial organization is computed differently than other businesses. Most notably, interest income (a subtraction for most businesses) is included in the tax base, and interest expense (an add back for most businesses) is an allowable subtraction in determining the tax base. Certain types of business organizations are per se financial organizations, such as a bank, a bank holding company, and a savings and loan association.

There is also a general test that treats certain forms of entities as financial organizations if 90 percent or more of their assets consist of intangible personal property and 90 percent or more of their income is from dividends, interest, and other charges for use of money or credit (the 90/90 test). The department's current position is that in the definition of a financial organization the statutory phrase "association, joint stock company, or corporation" means a corporation or any legal entity treated as a corporation for federal tax purposes (previously, the department looked solely at the legal form of the entity, and did not treat a partnership or LLC as a financial organization regardless of whether it was taxed as a corporation).

For example, per the department, if an LLC elects to be taxed as a corporation for federal purposes, the 90/90 test will be applied to the LLC. The 90/90 test will not apply to an SMLLC that is a disregarded entity (but presumably it will apply to the member if it is one of the specified forms of entity that can be a financial organization). If an SMLLC or a QSUB is one of the enumerated per se types of financial organizations (such as a bank or bank holding company), the 90/90 test will not apply and the entity will automatically be a financial organization. However, if a QSUB is not a per se financial organization, the 90/90 test will be applied to it since it is in legal form a corporation. (This is an apparent exception to the general SBT treatment of ignoring the existence of a QSUB).

Treatment of Owners and Compliance Matters

Where the SBT is applied at the entity level it is not applied again at the owner (member, partner, or shareholder) level (however, as discussed in Part II of this article, an individual owner will be subject to income tax).

Pass-through entities that are subject to SBT must obtain a taxpayer account number and file SBT returns. Under current law and administrative interpretations, only corporations (that also satisfy the SBT Act Section 77 requirements[9]) may request permission to file consolidated SBT returns. De facto consolidated returns can be accomplished using an SMLLC or a QSUB, since such entities are generally disregarded and

their assets treated as owned by their member or shareholder.

Look for Part II of this article regarding income tax, sales tax, use tax, employment withholding tax, real estate transfer tax, and real estate ad valorem tax in the August issue of the *Michigan Bar Journal.* ✦

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FOOTNOTES

1. See MCLA 208.1 et seq.
2. See Revenue Administrative Bulletin ("RAB") 1999-9. Michigan conforms to federal check-the-box regulations (Treasury Regulations Sections 301.7701-1 through 301.7701-3) for SBT purposes.
3. See RAB 2000-5. Michigan follows the consequences of a federal QSUB election for SBT purposes.
4. Since the legal form of the business entity is not changed by the check-the-box regulations, the entity should use its actual legal organization classification in the section titled "Organization Type" when filing its SBT return. In addition, the first four pages of the federal return, which reflect the entity classification for federal tax purposes, should be attached to the SBT return, along with a copy of the federal form 8836 Entity Classification Election (if filed). In the case of an SMLLC, the member files the return.
5. See RAB 1992-3 that describes how the CAD recapture rules apply to certain types of tax-free reorganizations. The department has not yet issued a similar bulletin dealing with ITC recapture, but the "Frequently Asked Questions" about the ITC posted on its website state that for ITC recapture the department will use the concepts applicable to CAD recapture as expressed in RAB 1992-3.
6. See RAB 1992-3, Section 3.E(8).
7. Under the prior regulations under Section 708(b), the termination of a partnership because of a change in ownership was deemed to cause the following: First, the old partnership distributed its assets in liquidation to its partners. The partners (including the new partner(s)) were then deemed to contribute the assets back to a new partnership. Under the current regulations, Section 1-708-1(b), the termination causes the following to occur: First, the old partnership distributed its assets in liquidation to a new partnership. Next, the old partnership liquidates and distributes the interests in the new partnership to its partners.
8. See RAB 2002-16 dealing with the definition of a "financial organization."
9. SBT Act Section 77 requires that corporations wishing to apply to file a consolidated tax return must also meet the following requirements: (1) each corporation must be a member of the same affiliated group (generally speaking, there must be common ownership of at least 80 percent of each corporation); (2) each corporation must be subject to the SBT; (3) each corporation must use the same apportionment formula; and (4) each corporation must have substantial intercompany transactions with another member of the affiliated group.