

Michigan Taxation of Pass-Through Entities (Part II)

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 (*Michigan Bar Journal*, July 2003) discussed single business tax (SBT). The following Michigan taxes will be addressed in Part II of this article:

- Individual income tax
- Sales tax
- Use tax
- Employment withholding tax
- Real estate transfer tax
- Real estate ad valorem tax

The analysis is structured by the type of tax. The various types of pass-through entities will be examined within the discussion of each tax.

Income Tax

Michigan does not impose income tax on any type of corporation, partnership, or limited liability company. It does impose income tax on individual (and trust and estate) owners of all types of pass-through entities. Individual owners of an entity taxed as a corporation are taxed only when dividends or other distributions are made to them. There is no credit or deduction given to an owner for his share of any SBT imposed at the entity level.

The entity classification for federal income tax is effective in determining the Michigan individual income tax treatment of the individual, shareholder, partner, or member (regardless of whether the taxpayer is a resident or nonresident of Michigan).¹ No separate entity classification election is made for Michigan income tax purposes. A Michigan resident is taxed on 100 percent of any

dividends he receives from an entity taxed as a corporation, whether its business is conducted in Michigan or other states. However, if a Michigan resident owns an interest in a pass-through entity that conducts business in states other than Michigan, his share of such income will be subject to apportionment.

Distributive shares of income from a partnership or an S Corp engaged in business have been held to be income derived from business activity that is subject to apportionment (instead of non-business income taxable only in the state where the owner is domiciled).² For income tax purposes, the apportionment formula (like the SBT apportionment formula) uses three factors, sales, property, and payroll, but in this case (unlike the SBT) each factor is equally weighted. In the case of a pass-through entity owned by individuals who are not residents of Michigan, if such entity conducts business in Michigan, its owners will be subject to Michigan income tax (on an apportioned amount) even if they have no other connection with the state.

If a nonresident owner of a pass-through entity is also an employee of such entity, all or a portion of any compensation earned for services may be subject to Michigan income tax.³ Such compensation is allocable to Michigan based upon the number of days worked in Michigan divided by the total number of days worked everywhere (considering only days worked for the entity). This should be contrasted with the Michigan taxable portion of income received as an owner of an S Corp, an LLC or a partnership, which is apportioned using the three-factor formula as described above.

Federally disregarded entities, such as SMLLCs and QSUBs, are also disregarded for Michigan income tax purposes. The income of a disregarded entity is reported directly by its member or shareholder.

"Tax Notes" is prepared by the Taxation Section of the State Bar. Some items are of primary interest to tax practitioners; others will be useful to lawyers in general practice. Since one purpose of "Tax Notes" is to afford an exchange of tax-related ideas, problems, and experience among Michigan lawyers, readers are invited to submit material for publication. For a copy of the publication guidelines, please contact column editor Steven E. Grob, Dykema Gossett, 35th Floor, 400 Renaissance Center, Detroit, MI 48243.

Sales Tax and Use Tax

In general, Michigan imposes sales tax on a retail seller of tangible personal property (TPP) and imposes a use tax on the purchaser of TPP that is used or consumed in Michigan without having been subject to the sales tax. The entity classification for federal income tax purposes has no bearing on sales or use tax. For sales and use tax purposes, Michigan treats all federal pass-through entities as separate taxpayers who must obtain account numbers and file separate sales and use tax returns.⁴

Employment Withholding Tax

Michigan imposes a payroll income tax withholding obligation and employer payroll taxes on all types of entities having employees in Michigan, regardless of their federal pass-through status. Any entity that is deemed an "employer" under Internal Revenue Code section 3401(d) is also an employer for Michigan income tax withholding. All such employing entities must obtain account numbers and file payroll tax returns. If the entity is disregarded for federal purposes and is not required to obtain a federal employer identification number (EIN), the department will issue a treasury (TR) number for Michigan income tax withholding. Also, the department may, upon request, enter an agreement to allow an SMLLC or a QSUB to file a combined withholding tax return with its member or shareholder.⁵

Real Estate Transfer Tax

In general, Michigan imposes a transfer tax on the transfer of title to real property located in Michigan. For purposes of this tax, Michigan's administrative policy is to respect the legal form of ownership, irrespective of such entity's classification for federal tax purposes. Therefore, in the case of any pass-through entity, (even a federally (and SBT) disregarded entity such as an SMLLC or a QSUB) the transfer of ownership of the entity will not be deemed to be a transfer of any real property owned by such entity, and the transfer tax will not be applicable.

The transfer tax must be considered when property is contributed to a pass-through entity or distributed out to one or more of its

owners. Many such transfers are federally income tax-free, but not all of them are transfer tax-free. For example, if real property is transferred from its owner to a pass-through entity, such transfer will be subject to the transfer tax unless one of several exceptions is met (such as a transfer to an entity that is 80 percent or more controlled by the transferor).⁶

Real Estate Ad Valorem Tax

In general, local jurisdictions in Michigan impose annual taxes on real property based upon its value. However, the permissible annual increase in the taxable value of real property is statutorily limited or capped. Unless a specific exemption applies, a transfer of the property will uncapped the taxable value in the hands of the transferee for future property tax assessments.

In the case of pass-through entities, a contribution of property to the entity or a distribution out to one or more of its owners may uncapped the taxable value of the property. The exceptions permitting certain transfers without uncapping are different from the exceptions permitting certain transfers without imposing the real estate transfer tax.⁷

Conclusion

For Michigan tax purposes, a federal pass-through entity is not consistently treated. In

some cases, it is given pass-through treatment or considered a disregarded entity following the federal rules. In other cases, it is taxed as a separate entity or given special treatment. Therefore, care must be taken in structuring business entities to avoid adverse consequences and to maximize planning opportunities. ♦

Steve Grob is a member of Dykema Gossett, PLLC, Detroit. He has over 25 years experience in federal and state tax planning and tax controversy matters. He is also a certified public accountant. Mr. Grob has been recognized in The Best Lawyers in America.

FOOTNOTES

1. See RAB 1999-9. Michigan's individual income tax is based on federal adjusted gross income (AGI). No specific Michigan income tax adjustments are allowed regarding entity classification. Also, see MCLA 208.36(1)(f), which defines "S corporation" as a corporation electing under section 1361 of the code.
2. See *Chocola v Dept of Treasury*, 422 Mich 229 (1985).
3. Rule 206.12 provides that salaries, wages, and other compensation received by a Michigan resident are allocated to Michigan, and further provides that salaries and wages earned in Michigan by a nonresident are allocated to Michigan. The income tax instructions state that the allocation for a nonresident is based on days worked in Michigan, divided by days worked everywhere.
4. See RAB 1999-9 and RAB 2000-5.
5. See RAB 1999-9 and RAB 2000-5.
6. See MCLA 207.526.
7. See MCLA 211.27a.