

Perspective

Single Business Tax

On June 29, the Michigan Legislature enacted the new Michigan Business Tax, which replaces the Single Business Tax. A compilation of five separate taxes, the Michigan Business Tax will take effect Jan. 1, 2008. In this article, author Patrick Van Tiflin provides an overview of the new tax regime and discusses how some changes may affect key decisions by taxpayers.

New, Five-Part Michigan Business Tax Replaces SBT, Leaving Many Questions Unanswered for Certain Taxpayers

BY PATRICK R. VAN TIFLIN

SURPRISE!

When asked by his wife where he wished to be buried, Yogi Berra is rumored to have responded, "Surprise me!" When multistate taxpayers awoke on Friday, June 29, 2007, they could not have been more surprised by what the Michigan Senate/House Conference Committee had adopted late the previous evening to replace the Single Business Tax (SBT).

The Legislature enacted the Michigan Business Tax (MBT) in an effort to simplify the Michigan tax structure and attract new businesses to the state through a combination of property tax cuts, job creation incentives, and changes in the apportionment formula that favor companies heavily invested in Michigan. But as with the SBT, there will be winners and losers. Many businesses will see their tax liabilities reduced under the MBT—but nearly a third could see them go up considerably. Insurance companies, real estate and financial firms, and companies without significant property or payroll in Michigan can expect their tax bills to increase.

A COMBINATION OF TAXES

The Michigan Business Tax (2007 PA 36) is actually a combination of five taxes. Thus, in comparison to the

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Single Business Tax, the MBT is quickly becoming known as the "Multiple Business Tax." The MBT scheme consists of an income tax (BIT), a gross receipts tax (GRT), a gross premiums tax on insurance companies, a bank capital tax on financial institutions, and a small business tax.

The Business Income Tax

The BIT is imposed upon business income, which is defined as that part of federal taxable income derived from business activity. For a partnership or an S corporation, business income includes payments and items of income and expense that are attributable to business activity of the partnership or S corporation and separately reported to the partners or shareholders. For a tax-exempt entity, business income means the unrelated business taxable income.

There are numerous additions to business income, including interest on obligations issued by other states, dividends that are deducted from federal taxable income, other net income taxes deducted from federal taxable income, and federal net operating losses. Subtractions include foreign-source dividends and income from pass-through entities that are subject to the MBT. Payers of the MBT may also subtract interest from U.S. obligations and net earnings from self-employment as defined under I.R.C. § 1402, except to the extent that the earnings represent a reasonable return on capital. Taxpayers may also subtract business losses incurred after Dec. 31, 2007, the sunset date for the SBT. Business loss carryforward is permitted for up to 10 years. The business income tax rate is 4.95 percent.

The Gross Receipts Tax

The gross receipts tax base includes virtually all amounts received unless specifically excluded. Major exclusions include amounts received in an agency ca-

capacity, transfers of accounts receivable, discounts, security deposits, like kind exchanges, refunds, and repayment of principal. Other exclusions from gross receipts include income from lawsuits or settlements (except to the extent included in federal taxable income), a return of basis on I.R.C. §1221(a) capital assets and I.R.C. §1231(b) property (land used in a trade or business), return of principal to sales finance companies, proceeds from the sale of mortgage loans, and reimbursement for wages and benefits to a professional employer organization.

For the 2008 tax year only, an MBT taxpayer is allowed to deduct from the gross receipts tax base 65 percent of any remaining SBT business loss carryforward incurred in 2006 or 2007. Note that for a multistate taxpayer, the business loss carryforward will have already been apportioned in the year incurred and, when carried forward into 2008, the SBT loss will be apportioned again. Thus, the limitation results in a deduction of less than 65 percent for a multistate taxpayer.

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Once gross receipts is constituted under the foregoing definition and exclusions, an MBT gross receipts taxpayer is allowed to subtract from gross receipts something called "purchases from other firms." These purchases are defined as inventory (including freight, shipping, delivery, or engineering charges), assets eligible for depreciation, along with materials and supplies, including repair parts and fuel. For a staffing company, purchases from other firms means compensation of personnel supplied to customers of staffing companies. For purposes of this subtraction, inventory is defined to be the stock of goods held for resale in the regular course of trade of a retail or wholesale business, including electricity or natural gas purchased for resale, as well as finished goods, goods in process, and raw materials of a manufacturing business purchased from another person. Inventory does not include personal property under lease or principally intended for lease, nor property which is allowed a deduction or allowance for depreciation or depletion. Purchases from other firms also include payments to subcontractors for a construction project.

Although it is very much like a sales tax, the gross receipts tax may not be passed onto customers by Michigan business taxpayers unless the business taxpayer is a new motor vehicle or personal watercraft dealer. The modified gross receipts tax under the MBT is imposed at a rate of .80 percent, and the MBT expressly declares that the tax is imposed upon the "privilege of doing business" and not upon income or property.

Premiums Tax

The premiums tax is imposed on insurance companies at the rate of 1.25 percent of gross premiums. This compares with a rate of approximately 1.07 percent that

was imposed on insurers under the SBT. The retaliatory tax continues as it was when insurers were under the SBT regime. Specific types of insurers continue to be eligible for credits for payments made to special facilities and associations established by the Insurance Code. The first \$180 million in disability insurance premiums continues to be exempt. In addition to suffering an increase in the tax rate, the insurance industry has also lost the exemption from use tax that was provided to insurers by the SBT "in lieu of" provision.

Financial Institutions

Financial institutions pay a bank capital stock tax on average net capital calculated over the last five years, multiplied by a rate of .235 percent. The statute classifies the tax as a franchise tax. This bank capital stock tax is in lieu of the business income and gross receipts taxes established by the MBT. Net capital is equity capital calculated under generally accepted accounting principles, less goodwill and U.S. and Michigan obligations. Under the single business tax, a financial organization was defined by reference to its income and assets. Under the bank capital stock tax, a financial institution is defined to mean a bank holding company, a national bank, a state-chartered bank, an Office of Thrift Supervision chartered bank, a thrift institution, or a savings and loan holding company other than a diversified savings and loan holding company defined in 12 U.S.C. §1467a(a)(1)(F), or any person other than an insurance company directly or indirectly owned by such an entity.

NEXUS

Since the MBT has multiple tax bases, different nexus standards apply to the different taxes. The BIT base, of course, is subject to Pub. L. No. 86-272. The gross receipts tax, since it is a privilege tax, is not subject to that limitation.

All persons with nexus conducting business activity in the state are subject to the tax. The definition of persons includes a corporation, partnership, limited liability company, receiver, estate, trust, individual, or any other group or combination of groups acting as a unit. Chapter 2 of the Act, which imposes the gross receipts tax, declares that a taxpayer has substantial nexus in the state and is subject to the tax if the taxpayer has a physical presence in the state for more than one day during the tax year or the taxpayer actively solicits sales in the state and has gross receipts of \$350,000 or more that are sourced to the state.

Physical presence means any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity, but not including activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in the state. The statute obligates the Michigan Department of Treasury to provide written guidance, which will be applied prospectively, on what the term "actively solicits" means.

UNITARY BUSINESS

One watershed change from the SBT regime to the MBT consists of a water's-edge unitary filing require-

ment. The statute requires a unitary business group to file a combined return that includes each U.S. person that is included in the unitary business group. Transactions between persons included in the unitary business group are eliminated from the business income base, the modified gross receipts tax base, and the apportionment formula. If a person included in the unitary business group is subject to the premiums tax or bank capital stock tax, any business income attributed to that person is eliminated from the business income base, any modified gross receipts attributable to that person are eliminated from the modified gross receipts base, and sales attributable to that person are eliminated from the apportionment formula.

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The statute defines a unitary business group as a group of U.S. persons, one of which owns or controls, directly or indirectly, more than 50 percent of the ownership interests with voting rights, or ownership interests that confer rights comparable to voting rights, of the other U.S. persons, and which has business activities or operations that result in a flow of value between or among persons included in the group, or which has business activities or operations that are integrated with, or dependent upon, or contribute to, each other. Flow of value is determined by reviewing the totality of the facts and circumstances of the business activities and operations.

Eighty/twenty companies are excluded from the unitary group. A foreign operating entity is defined as a person that has substantial operations outside the United States, the District of Columbia, the Commonwealth of Puerto Rico, and a territory or possession of the United States or a political subdivision of the foregoing and at least 80 percent of its income is active foreign business income as defined in I.R.C. §861(c)(1)(B). Thus, 80/20 companies having nexus with Michigan file a separate return. The statute does not address the status of foreign operating entities that do not have a permanent establishment.

For purposes of the business income tax, the business income of a unitary business group is the sum of the business income of each person included in the unitary business group, less any items of income and related deductions arising out of transactions, including dividends, between persons included in the unitary business group.

The modified gross receipts base of a unitary business group is the sum of the modified gross receipts of each person included in the unitary business group, less any modified gross receipts arising out of transactions between persons included in the unitary business group. If a member of a unitary business group has an SBT loss carryforward that was incurred in the 2006 or 2007 tax year, the loss may only be deducted against the modified gross receipts tax base of that person calculated as though the person was not included in the unitary business group. Recall that this deduction may only be used in 2008 and then only to the extent of 65

percent of any loss carried forward into 2008. As a consequence of the fact that different nexus standards apply to the business income tax and the gross receipts tax, it is conceivable that a different unitary group could exist for one tax than exists for the other.

APPORTIONMENT

All tax bases created under the MBT are apportioned using a single-sales factor. As a result, Chapter 3 of the MBT governing apportionment is filled with special rules for different types of activities. The general rule is that a taxpayer must apportion if it has business activities that are subject to tax both within and outside of Michigan. A taxpayer is considered subject to a tax in another state if it is subject to a business privilege tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, a corporate stock tax, or a tax of the type imposed under the MBT. A taxpayer is also considered to be subject to tax in another state if that state has jurisdiction to subject the taxpayer to one or more of these foregoing taxes, regardless of whether the state does or does not subject the taxpayer to such a tax. Thus, either actual or hypothetical taxation would be sufficient to obligate an MBT taxpayer to apportion its income.

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Sales of tangible personal property are considered made in the state if the ultimate destination of the property at the point that the property comes to rest is within the state, regardless of who pays transportation costs, or other conditions of the sale. Receipts from sale, lease, rental, or licensing of real property are in the state if the property is located within the state, while rentals of tangible personal property are in the state to the extent that the property is utilized in the state. This may be determined on a day-by-day basis based on the physical location of the property.

Receipts from the lease or rental of mobile transportation property are determined by the extent of property use within the state. Aircraft use is determined by the number of landings of the aircraft in the state. Extent of use can also be determined by determining the principal base of operations of mobile transportation property. Royalties or other income received for the use of, or for the privilege of, using intangible personal property are attributed to the state in which the property is used by the purchaser, which can be proportional in more than one state. If the proportion cannot be determined, the royalties or other income are excluded from both the numerator and the denominator.

Under the SBT, receipts for the performance of services were attributed based upon cost of performance. Under the MBT, receipts from the performance of services are in the state if the recipient of the services receives all of the benefit of the services within the state. If the benefit of the service is received in more than one state, the inclusion of the receipts is proportional to the extent that the recipient receives the benefit of the services in Michigan and elsewhere. There are special

rules for securities brokerage services, interest from loans secured by real property, interest from unsecured loans, receipts from credit card receivables, or the sale of those receivables, loan servicing fees, sale of securities or other assets from investment or trading activities, interest, dividends and other income from investment assets and activities and from trading assets and activities. Receipts from transportation services are attributable based upon revenue to miles, with special rules existing for maritime transportation services, passenger transportation, and the transportation of oil by pipeline (barrel miles) and gas by pipeline (thousand cubic feet miles). Telecommunication services generally are attributed based upon the place of primary use of the service.

To the extent that a taxpayer wishes to seek a modification of the statutory apportionment formula, the statute contains the typical UDITPA §18 relief from apportionment provision, coupled with a rebuttable presumption that business activity is fairly apportioned unless the constitutional distortion standards enunciated by the U.S. Supreme Court in *Hans Rees*¹ and *Norfolk & Western*² are established. The MBT apportionment relief provision is an improvement over that contained in the Single Business Tax Act, which employed mutually-exclusive rebuttable presumptions designed to prevent a taxpayer from ever demonstrating an unfair representation of business activity caused by the apportionment formula provisions.

Finnegan Rule Applies

The Michigan Legislature specifically adopts the *Finnegan* rule for purposes of determining the sales factor numerator of a unitary business group. Sales for a unitary business group include sales in the state of every person included in the unitary business group without regard to whether the person has nexus in the state. Sales between persons included in the unitary business group are eliminated in calculating the sales factor.

GEOFFREY

The Legislature has specifically embraced the *Geoffrey* issue and has incorporated it into the MBT. The business income tax base is determined by adding, to the extent deducted in arriving at federal taxable income, any royalty, interest, or other expense paid to a person "related" to the taxpayer by ownership or control for the use of an intangible asset if the person is not included in the taxpayer's unitary business group. The Legislature, thus, specifically intended to reach beyond the unitary group to capture any *Geoffrey*-like payments and return them to the business income tax base. A *Geoffrey* addback is not required if the taxpayer can demonstrate that the transaction:

- has a nontax business purpose other than avoidance of the MBT,
- is conducted with arm's-length pricing, rates, and terms, and

¹ *Hans Rees' Sons Inc. v. North Carolina*, 283 U.S. 123 (1931).

² *Norfolk & Western Railway Co. v. Missouri State Tax Comm.*, 390 U.S. 317 (1968).

■ is either (i) a pass-through of another transaction between a third-party and the related person, with comparable rates and terms, or (ii) results in double taxation (meaning the transaction is subject to tax in another jurisdiction), or (iii) is unreasonable as determined by the state treasurer, and the taxpayer agrees that the addition would be unreasonable based on the taxpayer's facts and circumstances.

ALLIED SIGNAL

The Michigan Legislature specifically intended to capture and subject to taxation all federal taxable income derived from business activity. The description of business activity is all-encompassing, including "the transfer of legal or equitable title to, or rental of, property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit or advantage, whether direct or indirect, to the taxpayer or others." The only recognized exclusions from business activity are the services rendered by an employee to an employer or services as a director of a corporation.

Note that the definition of business activity under the SBT excluded a casual transaction. A casual transaction was defined as a transaction "engaged in other than in the ordinary course of repeated and successive transactions of a like character" which is not "incidental" to the regular business activity of the taxpayer. The MBT contains no such casual transaction exclusion. The definition of a unitary business group crafted by the Michigan Legislature, coupled with the definition of business activity, shows a disregard of the unitary business principle of apportionment as outlined by a series of decisions on that issue by the U.S. Supreme Court.

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CREDITS

The MBT has dramatically expanded credits for taxpayers having significant operations in Michigan, compared to those credits available under the SBT. A compensation credit of .37 percent of compensation paid in Michigan has been incorporated into the MBT credit scheme. Inexplicably, this credit is granted to life insurance companies but is denied to insurance companies that are not life insurers. In addition, the investment tax credit, which previously existed under the SBT, continues under the MBT at the rate of 2.9 percent of net new capital assets placed in Michigan. These two credits must be taken first and cannot exceed 65 percent of tax liability. Other new, broadly applicable credits under the MBT include the research and development credit, which is 1.9 percent of research and development expenditures in Michigan and 30 percent of contributions to small businesses for research and development,

capped at \$300,000. A new entrepreneurial credit is available for 2008-2010 if the taxpayer's gross receipts do not exceed \$25 million dollars, the taxpayer has created 20 new jobs in Michigan, and has made at least \$1.25 million in capital expenditures. The credit is equal to the marginal tax generated from the added employment in the state.

To the great relief of many SBT taxpayers who responded in past years to these incentives, most of the other major SBT credit programs continue under the MBT, including the Michigan Economic Growth Authority credit, Renaissance Zone credit, historic preservation credit, brownfield development credits, venture capital investment credits, charitable contributions, start-up business credit, and homeless shelter and food bank credit.

PERSONAL PROPERTY TAX RELIEF

The MBT grants substantial relief from Michigan personal property tax liability. Under four bills which were enacted in conjunction with the creation of the MBT, the property tax laws of Michigan were modified to provide a 24 mill reduction for industrial personal property, including property which is subject to an industrial facilities tax certificate, a 12 mill reduction for commercial personal property, a refundable 35 percent credit against MBT for taxes paid on industrial personal property, as well as a refundable 23 percent credit for personal property taxes paid by telephone companies, and a 10 percent refundable credit for personal property taxes on natural gas pipelines. These special millage reduction provisions and refundable MBT credits are limited to personal property. As a consequence, the proper classification of property as either real or personal, and as industrial or commercial, becomes much more critical than it may have been in prior years. An improper classification of property must be addressed early in the year in order to secure a property reclassification.

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COMPLIANCE MATTERS

The MBT becomes effective Jan. 1, 2008, and a fiscal year taxpayer must begin the determination of MBT liability as of that date. The statute offers fiscal-year taxpayers an election to either:

- report the entire fiscal year which ends in 2008 under the MBT, multiplied by a ratio of the numbers of months in the tax year included under the MBT divided by 12, or alternatively,

- to use what is referred to as the actual method, reporting liability under the MBT only for those months beginning after Dec. 31, 2007.

Surprisingly, the MBT does not provide any penalty relief for taxpayers who do not accurately estimate the liability under this dramatically different and unique state tax provision. Quarterly estimates for calendar year taxpayers are due on January, April, July, and October on the 15th of the month, with corresponding dates for fiscal year filers. Penalties will not be assessed if estimated payments equal or exceed 85 percent of tax liability and a reasonable approximation per quarter, or, for tax year 2009 and thereafter, if the prior year's tax is \$20,000 or less, the prior year's amount is paid in four equal payments.

REFUND OF EXCESS TAX COLLECTIONS

The Department of Treasury informed the Legislature that the MBT as previously described would not produce more than the approximately \$1.9 billion in revenues generated by the SBT in the last year for which reliable revenue figures were available. A skeptical business community prevailed upon the Legislature to place a refund mechanism in the statute, which calls for a refund of excess tax collections to taxpayers making net cash payments. The refund provision is triggered if net cash revenues exceed the revenue estimate provided by the Department of Treasury plus 1 percent, and the amount of the excess is more than \$5 million dollars. Only in this circumstance, 50 percent of the excess revenue is to be refunded to taxpayers making net cash payments. Net cash means annual and estimated payments made during the fiscal year, less refunds. The fiscal year spoken of in this context is the fiscal year of Michigan which ends Sept. 30.

CONSIDERATIONS FOR TRANSITIONING TO THE NEW TAX

As we leave the SBT regime and move to the Michigan Business Tax, it is well to consider those items which may or not be taxable under the SBT whose nature is no longer relevant under the MBT. For example, interest income, dividend income, and royalty income are not taxable under the SBT. To the extent that those items can be accelerated into 2007, the taxpayer will probably be better served. Note as well that compensation expense, interest expense, dividend expense and royalty expense increase the SBT base and therefore, to the extent possible, should be deferred into 2008. This is particularly true of compensation expense since compensation paid to employees in Michigan in 2008 will be eligible for the compensation credit. Other items that increase the SBT base that should be deferred include capital acquisition deduction recapture transactions, other state net income taxes, capital loss carryovers or carrybacks and losses from partnerships.

CONCLUSION

I think even Yogi would be surprised.