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TREASURY'S RETROACTIVE APPLICATION OF THE KMART RULING: WHAT IT MEANS AND HOW MICHIGAN TAXPAYERS WILL BE AFFECTED

On February 5, 2010, the Department of Treasury (Treasury) issued a Notice to Taxpayers explaining its enforcement policy for the decision in *Kmart Michigan Property Services LLC v Dep't of Treasury (Kmart)*. Below is a summary of that Notice and a discussion of *Kmart's* practical implications.

Summary of Notice to Taxpayers

Kmart Decision: At issue in *Kmart* was whether an entity that is disregarded for federal income tax purposes is considered a separate taxpayer under Michigan's Single Business Tax Act (SBT). Although Treasury, in RAB 1999-9, had issued guidance stating that entities disregarded for federal tax purposes are disregarded entities for SBT purposes, the Michigan Court of Appeals concluded that the plain language of the SBT requires all entities defined as a "person" to file a separate tax return even if disregarded for federal income tax purposes.

Retroactive Enforcement: Treasury is enforcing *Kmart* with full retroactive effect. Therefore, all previously disregarded entities are required to file separate SBT returns.¹ Additionally, all owners of entities that were previously treated as disregarded entities for SBT purposes must file amended returns to exclude the previously included income, expenses and tax attributes of the disregarded entity.

Statute of Limitations: The owners of previously disregarded entities must file amended SBT returns for all open tax periods. Under MCL 205.27(a), the statute of limitations for amending a return is generally four years. According to the Notice, previously disregarded entities, because they did not file a separate SBT return, are considered non-filers for statute of limitations purposes and must file SBT returns for all tax years during which they conducted business activity in Michigan.

Interest and Penalties: Interest is due on any deficiencies accruing from the time the tax was originally due. Interest on refunds accrues from 45 days after the claim is filed. Failure to file penalties will be waived for all returns filed and paid by **September 30, 2010**.

Positive Implications of Notice

Lack of Nexus: Filing as a separate SBT taxpayer may be beneficial to certain LLCs that have no physical presence in Michigan other than through its single member. Under RAB 1998-1, certain out-of-state single member LLCs will not be subject to SBT because lack of physical presence means no nexus with Michigan. Thus, such LLCs' items of income and deduction may be outside Michigan's taxing jurisdiction.

Filing Threshold: A single member LLC, when viewed separately from its owner, may not have sufficient gross receipts to be required to file an SBT return under the SBT. In general, a person engaged in business activity in Michigan must have \$350,000 of Michigan-based gross receipts to be obligated to file an SBT return. A previously disregarded entity that is also a member of a group of entities under common control that collectively has more than \$350,000 in apportioned gross receipts must file an SBT return if its separate gross receipts equal \$100,000 or more.

Tax Attributes: Single member LLCs that must now file a separate SBT return may qualify for the small business credit and other previously unavailable tax attributes. In *Alliance Obstetrics &*

¹ Disregarded entities that do not have a Federal Employer Identification Number or Michigan Treasury Assigned Number must register with Treasury before filing an SBT return.

Detroit



Lansing



Oakland County



Ann Arbor



Kalamazoo

Gynecology, PLC v Dep't of Treasury (in which Honigman SALT attorneys represented *Alliance*) the Court of Appeals held that, an LLC is entitled to the SBT Small Business Credit, even though one or more of its members earns more than the \$115,000 in corporate officer compensation that would disqualify a corporation from taking the credit.

Negative Implications of Notice

Double Taxation: Since previously disregarded entities and their owners have different retroactive periods for the filing corrected SBT returns, some of the affected entities will be subject to double taxation. For example, if the corporate owner of a single member LLC included the LLC's income in its 2002-2007 SBT return, the corporate owner can only claim a refund for years that are open under the statute — 2006 and 2007. The LLC, on the other hand, must file separate returns going back to 2002. Consequently, for the 2002-2005 tax years, the tax on the LLC's earnings will be collected twice: once when included on the corporate owner's original return and again when the LLC files its post-*Kmart* returns.

Personal Liability for SBT, Interest and Penalties for Responsible Members: Under MCL 205.27a(5), officers, members, managers, or partners who have control of, or responsibility for, filing SBT returns or making associated payments may be held personally liable for any unpaid SBT, interest and penalties if the previously-disregarded entity fails to comply with the Notice.

Effect on MBT Returns: The Notice only addresses the SBT enforcement of the *Kmart* decision. It is questionable whether under *Kmart*, disregarded entities must also file separate Michigan Business Tax Act (MBT) returns. Treasury's representatives recently indicated that they are "aware" of the differences between the relevant statutory language of the SBT and the MBT. Taxpayers may need to review their 2008 MBT filing. Due to the impact of the Notice on certain carryforwards, FAS 109 and other credits and required disclosures, taxpayers should review their 2008 MBT returns for possible amendment.

OBSERVATIONS: TAXPAYERS SHOULD TAKE TIME TO EVALUATE THE IMPACT OF SEPARATE FILINGS FOR DISREGARDED ENTITIES BEFORE TAKING ANY ACTION. IN ADDITION, THERE MAY BE SOME BASES FOR QUESTIONING THE REQUIREMENTS SET FORTH IN THE NOTICE. TAXPAYERS SHOULD CONTACT THEIR HONIGMAN TAX LAWYER FOR FURTHER INFORMATION AND ADVICE ON THEIR FACTUAL SITUATION.

BUSINESS COALITION FORMING: TAXPAYERS INTERESTED IN JOINING WITH OTHER BUSINESSES TO WORK FOR A CHANGE IN THE ENFORCEMENT POLICY OR IN LEGISLATION ARE ENCOURAGED TO CONTACT THEIR HONIGMAN SALT LAWYER FOR MORE INFORMATION.