THE MICHIGAN TAX IMPLICATIONS OF THE COURT OF APPEALS' RULING THAT THE FEDERAL CHECK-THE-BOX REGULATIONS DO NOT APPLY TO MICHIGAN'S SINGLE BUSINESS TAX

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I. Introduction.

In *Kmart Michigan Property Services, LLC v Department of Treasury* ("*Kmart Services*")[1], the Michigan Court of Appeals recently ruled that the federal "check-the-box" regulations (the "*Federal Regulations*") do not apply to the Michigan Single Business Tax ("*SBT*") Act. The *Kmart Services* decision rejected the Michigan Department of Treasury's ("*Department*") Revenue Administrative Bulletin ("*RAB*") 1999-9[2] which applied the Federal Regulations[3] to single member limited liability companies ("*LLCs*") under the Michigan SBT Act.

On June 23, 2009, the Department appealed the Court of Appeals' decision to the Michigan Supreme Court.[4] In its Application For Leave To Appeal ("*Application*") to the Supreme Court, the Department requests that leave to appeal be granted because:

> "[I]f the Court of Appeal[s'] decision stands, [it] will upset the settled expectations and tax planning of many taxpayers, and create uncertainty [in] the tax payment process. Although the Court of Appeals' decision happens to be to

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[1] *Kmart Michigan Property Services, LLC v Department of Treasury* (Court of Appeals Case No. 282058; May 12, 2009).

[2] RAB 1999-9 (dated November 29, 1999, but effective January 1, 1997).

[3] Effective on January 1, 1997, under the Federal Regulations an eligible domestic entity is permitted to elect its entity classification or is classified under certain "default" provisions. Treas. Reg. § 301.7701-1 to § 301.7701-3. Under the Federal Regulations, a single member eligible entity may elect to be taxed as a corporation or, by default, is not recognized as an entity for federal income tax purposes separate from its owner. A single member entity that is disregarded as a separate entity is treated as a sole proprietor, branch or division of its owner. Treas. Reg. 301.7701-1(4) states that "[u]nder §§ 301.7701-2 and 301.7701-3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners." Treas. Reg. 301.7701 -3(a) provides in part as follows:

> "A business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity ... with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election...."

The default classification under Treas. Reg. 301.7701-3(b)(ii) provides that "unless the entity elects otherwise," a domestic eligible entity shall be "[d]isregarded as an entity separate from its owner if it has a single owner."

[4] *Kmart Michigan Property Services, LLC v Department of Treasury* (Michigan Supreme Court Case No. 139110).

> the financial advantage of the taxpayer in this particular case, the overruling of Treasury's longstanding practice of respecting federal tax elections will hurt more taxpayers than it will help…." (Application, p 1).

While, as stated in the Department's Application, there will be "winners" and "losers" under the *Kmart Services* decision, many taxpayers (and their advisors) will be surprised to learn that their reliance on the Department's RAB 1999-9 was misplaced. Unfortunately, taxpayer reliance on the Department's RAB may be no defense to action taken by the Department to apply *Kmart Services* retroactively to impose single business taxes on single member LLCs and their owners.[5]

While the Department has appealed the Court of Appeals' decision to the Supreme Court, the Department is presently considering how to apply the Court of Appeals' decision (prospectively vs. retroactively) and whether the decision applies to single member LLCs under the Michigan Business Tax ("*MBT*") Act.

This article discusses the Department's longstanding position on the Federal Regulations, the Court of Appeals' decision in *Kmart Services*, and some of the implications of the Court of Appeals' ruling under the SBT and MBT Acts.

II. RAB 1999-9 and Single Member LLCs.

On November 29, 1999, the Department issued RAB 1999-9 (entitled "Effect of Federal Entity Classification Election On Michigan Taxes"). The RAB states that the Federal Regulations apply to the Michigan Income Tax Act of 1967 and to the SBT Act[6], but that the Federal Regulations do not apply for Michigan withholding tax purposes or to the Sales or Use Tax Acts.

In applying the Federal Regulations to the SBT Act, the RAB states the Department's position as follows:

> I. Michigan conforms to federal check-the-box regulations [Treas. Reg. § 301.7701-1 through § 301.7701-3] for SBT purposes. The entity election or default classification for filing the federal income tax return is effective for all components of the SBT return that are related to federal income tax. Further, the federal tax treatment of an elective change in classification is determined under all relevant provisions of the Internal Revenue Code (IRC) and general principles of tax law. **A taxpayer who elects entity classification at the federal level shall file the Michigan SBT return on the same basis and reflect the same tax consequences**.

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[5] See, *International Home Foods, Inc. v Dept of Treasury*, 477 Mich 983 (2007) rev'g., 268 Mich App 356 (2005); *Rayovac Corp v Dept of Treasury*, 264 Mich App 441 (2004) ("The [Department] is not estopped from retroactively applying the new rule created by case law simply because it had issued revenue administrative bulletins advising taxpayers of what the then-applicable rule was…."); *J.W. Hobbs Corp v Dept of Treasury*, 268 Mich App 38 (2005); *Hoffman-Laroche, Inc. v Dept of Treasury* (Michigan Court of Appeals, Case No. 252770; 3/08/2005).

[6] 1975 PA 228 (effective January 1, 1976).

If a single member unincorporated entity is disregarded as an entity separate from its owner (a tax nothing) at the federal level it is treated as a branch, division, or sole proprietor for SBT purposes.

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III. No entity classification election is required or allowed at the state level for SBT or Individual Income Tax because Michigan follows the federal election.

IV. Under Treas. Reg. § 301.7701-2, if a single member entity is disregarded for federal income tax purposes, its activities are included as a part of the owner's activities in the respective sole proprietorship, branch, or division of the owner. Therefore, income, deductions, credits, assets and liabilities of a single member entity having nexus with Michigan, who elects to be disregarded as an entity for federal income tax purposes, are deemed to be those of the owner…

V. The property, payroll, and sales (or special formulas for certain businesses) of the combined entities are used to determine the apportionment factors for SBT and Individual Income Tax of a single member entity and its owner if the single member entity is disregarded at the federal reporting level. Inter-entity sales between the single member entity and its owner are disregarded when computing the sales factor.

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VIII. **As it applies to the federal check-the-box regulations, this RAB will be considered to be in effect beginning on January 1, 1997, the effective date of the federal regulations**…." (Emphasis added)

As explained below, the Court of Appeals in *Kmart Services* specifically and unequivocally rejected the Department's longstanding position that the Federal Regulations' treatment of single member LLCs applies to the SBT Act.

III. Kmart Services Rejects RAB 1999-9.

In *Kmart Services* the Court of Appeals affirmed the decision of the Michigan Tax Tribunal ("*MTT*") in favor of Kmart. The facts in the case are summarized in the Court of Appeals' opinion as follows:

"KMPS was a limited liability company (LLC) formed in Michigan and wholly owned by its single member, Kmart Corporation ("Kmart"). During the period at issue, KMPS had three employees and was responsible for winding up the business affairs of Builders Square, its former subsidiary, whose assets were sold to a third party. KMPS filed a single business tax (SBT) return for the fiscal year ending January 28, 1998. … [T]he Department audited KMPS … and determined that KMPS should not have filed a separate SBT return, but should have submitted their income, deductions, credits, assets and liabilities with those of Kmart, its parent corporation, for the tax year at issue. The Department

> determined that it would not accept KMPS's SBT return for the period at issue and would "disregard the entity and treat it as a division of its owner."
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> KMPS argued that it met the definition of a "person" under MCL 208.6(1) of the Single Business Tax Act (SBTA), MCL 208.1*et seq.*, qualifying it to file a separate SBT return for the period at issue… The Department argued … that KMPS was not a person under the SBTA, but rather a single member LLC. In addition, the Department argued that because KMPS elected to be a nonentity for federal tax purposes for tax year 1998, it could not choose to be an entity for purposes of its state SBT filing.
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> * * * [The MTT] found that KMPS was entitled to file a separate SBT return for the tax period at issue."

While not discussed in the Court of Appeals' decision, the Department's Application filed with the Supreme Court explains the state tax benefit obtained by Kmart Corporation's decision to not include its subsidiary LLC in Kmart Corporation's SBT return. By filing a "separate" SBT return, the subsidiary LLC claimed a large bad debt deduction in calculating the LLC's business income under the SBT Act. The Department's Application states:

> "KMPS was a single-member limited liability company (SMLLC) formed and wholly owned by its parent, Kmart Corporation (Kmart). For the tax year in issue, KMPS chose to be a disregarded entity of Kmart for federal income tax purposes. However, for the same tax period, KMPS filed a Michigan single business tax (SBT) return separate from its parent. <u>On this separate return, KMPS took a bad debt deduction, after declaring a $1.1 billion promissory note it held on another Kmart subsidiary (Builders Square, Inc.) to be worthless</u>…." Application, p. 8. (Emphasis added)

In rejecting RAB 1999-9, the Court of Appeals held that single member LLCs are "persons" and "taxpayers" under the SBT and <u>must</u> file separate SBT returns. The Court said:

> "<u>Under the SBTA, "every person with business activity in the state" was **required** to pay the SBT.</u> MCL 208.31(1). "Person" was defined as, "an individual, firm, bank, financial institution, limited partnership, copartnership, partnership, joint venture, association, corporation, receiver, estate, trust, or any other group or combination acting as a unit." MCL 208.6… The Department conceded that a "person" with business activity in Michigan is subject to pay the SBT, but argues that KMPS's election for federal tax purposes overrides its legal status in Michigan for state tax purposes.
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> The Department argues that Michigan's SBT utilizes the same "check-the-box" regulations that the federal income tax rules use, relying on Revenue Administrative Bulletin (RAB) 1999-9, …
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> [W]e conclude that the Department's legal rationale is inconsistent with the plain language of the SBTA…
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> Looking simply at the provisions of the SBTA, KMPS was **required** to file a SBT return, regardless of its classification as a disregarded entity for federal tax purposes, because KMPS fit within the statutory definition of a "person" conducting business activity and the SBTA **required** all persons conducting business activity in the state to file a SBT return. Therefore, the SBTA does not support the requirement of RAB 1999-9 that an organization that is a disregarded entity for federal tax purposes for a given taxable period must also file as a disregarded entity for state tax purposes…." (Emphasis added).

As aptly stated in the Department's Application filed with the Supreme Court, the *Kmart Services* decision would appear to "upset the settled expectations and tax planning of many taxpayers". Application, p 1.

IV. Does *Kmart Services* Also Reject the Department's Position that the Federal Regulations Apply to the MBT Act?

The MBT Act replaced the SBT Act effective for tax periods beginning on or after January 1, 2008.[7] In its "frequently asked questions and answers" ("*FAQs*") applicable to the MBT Act, the Department applies the Federal Regulations to single member LLCs.

In FAQ Mi25[8], the Department said:

> "Does the MBT follow the federal check-the-box regulations?
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> Answer. Yes. Effective January 1, 1997, a separate business entity that is not required to be classified as a corporation for tax purposes is permitted to elect its entity classification under the federal "check-the-box" provisions of the Federal Income Tax Regulations, Treas Reg § 301.7701-3. These check-the-box regulations allow an unincorporated entity, such as a limited liability company ("LLC"), to elect to be taxed as a corporation. An unincorporated entity with at least two members that fails to elect corporate tax treatment will, by default, be taxed as a partnership. An unincorporated entity with one member that fails to elect corporate tax treatment will, by default, be disregarded as an entity separate from its owner for federal tax purposes. A single member entity, such as a single member LLC ("SMLLC"), that is disregarded for federal tax purposes will be treated as a sole proprietorship, branch, or division of its owner.
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> For MBT purposes, a person[9] is defined in MCL 208.1113(3) to include various types of entities, including partnerships, corporations, and LLCs. An entity that

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[7] 2007 PA 36.

[8] See also, FAQ Mi28.

[9] The MBT Act (MCL 208.1113(3)) defines a "person" as follows:

has elected or is required to file as a corporation or partnership under the Internal Revenue Code is by definition a corporation or partnership under the MBT act, MCL 208.1107(3) and 208.1113(2). **These statutory definitions effectively adopt the federal check-the-box regulations for MBT purposes.**

To the extent a SMLLC is a disregarded entity for federal tax purposes, the owner of the SMLLC is the MBT taxpayer[10], and the SMLLC will be treated as either a sole proprietorship or as a branch or division of its owner. A SMLLC will be the MBT taxpayer only if it elects to be taxed as a corporation under the federal check-the-box regulations and is not part of a unitary group." (Emphasis added)

Not surprisingly, in the Department's Application filed with the Supreme Court, the Department states that the Court of Appeals' decision in *Kmart Services* may require (non-unitary) single member LLCs to file "separate" returns under the MBT Act.[11]

While the terms "person" and "taxpayer" are not identical in the SBT and MBT Acts, in its MBT FAQs the Department has adopted substantially the same position stated in RAB 1999-9. However, unlike the SBT Act, the MBT Act expressly incorporates the "unitary" business concept. In so doing, single members LLCs that meet the MBT Act's definition of a "unitary business group" ("*UBG*") should be included in the MBT return filed by the UBG.[12]

"(3) "Person" means an individual, firm, bank, financial institution, insurance company, limited partnership, limited liability partnership, copartnership, partnership, joint venture, association, corporation, subchapter S corporation, limited liability company, receiver, estate, trust, or any other group or combination of groups acting as a unit."

The MBT Act (MCL 208.1103) also incorporates certain terms used in the federal Internal Revenue Code. Section 1103 states that:

"A term used in this act and not defined differently shall have the same meaning as when used in comparable context in the laws of the United States relating to federal income taxes in effect for the tax year unless a different meaning is clearly required. A reference in this act to the internal revenue code includes other provisions of the laws of the United States relating to federal income taxes."

10 The MBT Act (MCL 208.1117(5)) defines a "taxpayer" as "a person or a unitary business group liable for a tax, interest, or penalty under this act."

11 In its Application, the Department states:

"… Apart from the fact that the same reasoning might be applied to interpretation of the new Michigan Business Tax Act, there are many pending cases filed that also involve legitimacy of federal "check the box" elections in a variety of contexts, as to which the reasoning [of the Court of Appeals] might be deemed to apply." (Application, p 12, note 16) (Material in brackets added)

12 MCL 208.1117(6) defines a UBG as follows:

"Unitary business group" means 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."

V. Conclusion.

While the Department has appealed the *Kmart Services* decision to the Supreme Court, the Department is presently considering how to apply the Court of Appeals' decision (prospectively vs. retroactively) and whether the decision applies to single member LLCs under the MBT Act.

Under the Michigan Revenue Act, generally there is a 4 year statute of limitations applicable to the Department's efforts to assess SBT taxes against taxpayers. Similarly, there is a 4 year statute of limitations that generally applies to refund claims.[13] Unfortunately, for those single member LLCs who relied upon RAB 1999-9 and were included in their owners' SBT returns, a serious question arises as to whether or not the single member LLC can now rely upon the 4 year statute of limitations (or other legal theories) to bar collection and assessment action by the Department.[14] For these LLCs, it is possible that they will be subject to SBT assessments for all "open" tax years going back to the January 1997 effective date of RAB 1999-9.

For some single member LLCs, however, the result in *Kmart Services* may present an SBT refund opportunity and, since these LLCs did not file their "own" SBT returns, these "taxpayers" may be able to claim refunds for all open SBT tax years.

If *Kmart Services* is applied retroactively by the Department, the owners of single member LLCs will be burdened with the compliance costs to prepare and file "separate" amended SBT returns to remove the income, credits, deductions, etc. of their single member LLCs from the owner's tax return. Additional compliance costs will also be incurred to prepare "separate" SBT returns for the single member LLC.

Finally, the answers to the issues raised in this article will not be known until after the Supreme Court acts on the Department's pending Application For Leave To Appeal. In the meantime, taxpayers that may be beneficially affected by the Court of Appeals' decision should consider filing protective refund claims with the Department of Treasury.

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[13] See, MCL 205.27a(2) ("A deficiency, interest, or penalty shall not be assessed after the expiration of 4 years after the date set for the filing of the required return or after the date the return was filed, whichever is later. The taxpayer shall not claim a refund of any amount paid to the department after the expiration of 4 years after the date set for the filing of the original return…."). The 4-year statute of limitations may be tolled by state or federal tax audits or by written waivers signed by taxpayers and the Department. See, MCL 205.27a(3).

[14] See, *infra*, footnote 5.